FLASH REPORT

ON KEY ECONOMIC AND FINANCIAL DEVELOPMENTS BASED ON THE JANUARY-SEPTEMBER 2005 DATA

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MAIN INDICATORS

	2002	2003	2004	2005 exp. in Flash Report of	
	fact		prel.fact	July	October
			volume change over the previous year, %		
Gross Domestic Product	3,5	3,4	4,6	3,5 - 4	3,5 - 4
Domestic use of GDP	5,5	6,2	2,8	2,5 - 3	2 - 3
of which: household consumption	9,4	7.8	3,1	3 - 3,5	cc. 3
gross fixed capital formation	9,3	2,5	8,4	5 - 7	6 - 8
Foreign trade turnover (goods and services)					
Export volume change	3,9	7,8	16,4	9 - 11	9 - 11
Import volume change	6,5	11,1	13,2	8 - 10	7 - 9
			change in percentage of previous year		
Gross average wages	18.3	12.0	8,2*	6 - 7	6 - 8
Net average wages	19.6	14.3	7,1*	8 - 9	8 - 10
Real wages, per employee	13.6	9.2	0,3*	4 - 5	4 - 6
Number of employees	0.1	1.3	-0.5	0 - 0,5	0 - 0,5
Unemployment rate (ILO), %	5.8	5.9	6.1	cc. 6,5	6,8 - 7
Consumer price index (annual average)	5.3	4.7	6.8	3,5 - 4	3,5 - 4
					at current prices
Deficit of foreign trade balance, Euro billion	3.4	4.2	3,9	cc. 3,5	3,3 - 3,5
Current account deficit, Euro billion	4.9	6.4	7.1	7,2 - 7,5	7,1 - 7,3
					in percentage of GDP
ESA95 general government deficit**	8,4	6,5	5,4	3,6	6,1
Current account deficit	7.2	8.8	8.8	8,3 - 8,8	8,1 - 8,4

*/ Adjusted for the change of the one month bonus payout in the public sector
**/ With the effect of pension reform

Introduction

As a result of the external economic environment, which was less favourable than originally projected but showed a gradual improvement, the Hungarian economy continued to develop on its export- and investment-driven growth path. The increasing diversification of the countries receiving Hungarian exports also supported that growth path. As a result of the slightly improved economic environment, manufacturing investments continued to expand dynamically, and the dynamic motorway construction also contributed to the fast investment growth.

The trade balance has improved significantly due to favourable export growth and also the very low import growth during the first six months caused mostly by one-off factors. Thus, the trade deficit is expected to be lower for the entire year as well than in 2004. The current account balance to GDP ratio is expected to improve for the whole year, while the inflow of EU transfers may result in an even greater improvement in the external financing requirement.

Monetary conditions eased in 2005, but the nominal interest rates are still higher than in neighbouring countries. The general government figures changed primarily due to methodological reasons, the lower-than-expected cash-based deficit of Q3 reflects the measures taken in the first half-year to assure compliance with the deficit target.

Inflationary trends, net of the effects of increasing energy prices, are characterised by the continued slow-down of inflation growth. As a highly favourable sign for the medium-term outlook, the core inflation indicator sank below 2% after mid-year.

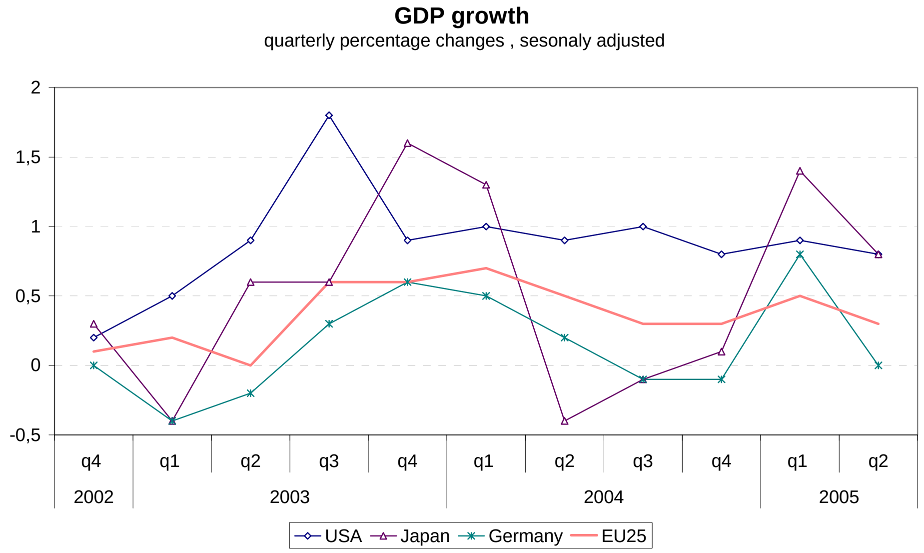
Declining inflation and the amendment of the PIT Act this year – which resulted in the net earnings in the national economy growing faster than gross earnings – facilitate a substantial real wage increase even against the background of lower wage outflow growth.

Based on the above, growth around the high edge of the 3.5-4% range is expected for 2005, with a balanced structure and improving external equilibrium.

1. External economic environment

Global growth continued at a lower rate

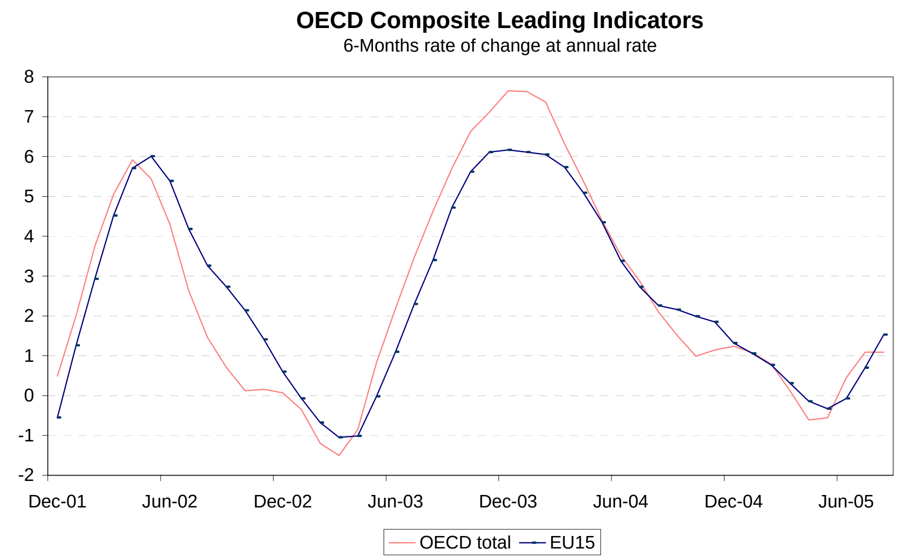
The entire global economy showed a relatively dynamic growth in 2005, being slightly slower than originally expected in the first half-year. Growth continues to be attributable to the US (3.6%) and the fast-growing Asian countries, mainly China (approx. 9%), but overall growth trend in South America has also been favourable.



Slightly improving outlook from the second half-year

After the worse-than-expected global economic output in the first six months, a slight economic upturn is projected for the second half of the year. The composite indicator of the OECD[1], which is used to forecast the turning points in business cycles, has been increasing for the third consecutive months in August. This reinforces expectations of a slight increase in the forthcoming period in the OECD as a whole.

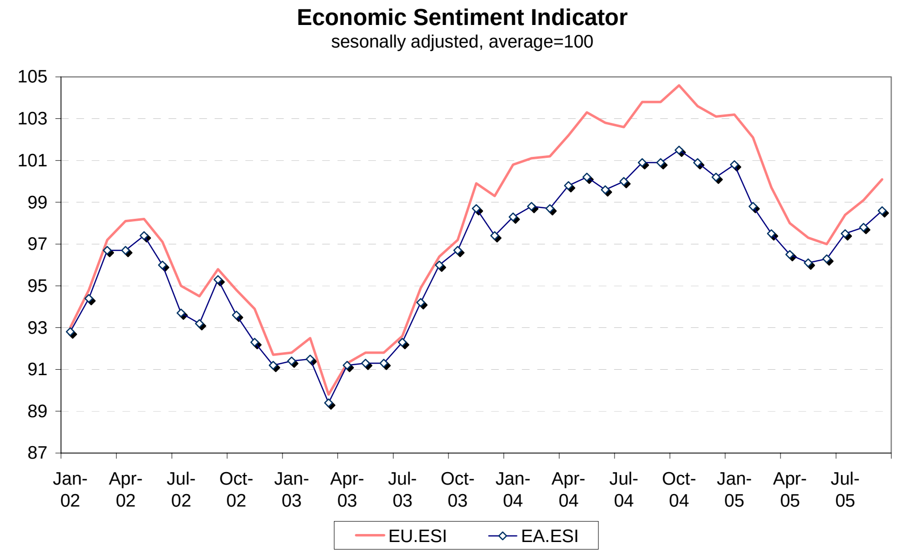
in OECD countries…



[1] OECD Composite Leading Indicator (CLI), 7 October 2005

EU forecasts[2] envisage growing household consumption and investments in the second half-year. The pickup of household demand is indicated by the increase of the volume of retail trade turnover in August (Euro area on a year-on-year basis: 2%, 0.9% in July; EU25: 2.2%, 0.7% in July). The upswing of demand in the EU export markets and the delayed effect of the weakening of the Euro in the first half-year may promote higher export figures in the second half of the year. The composite business and consumer confidence index (ESI) for the EU and the euro area showed a marked improvement for the fourth time in September, which indicates that despite the major uncertainty of energy prices, the deteriorating trend that started in the autumn of 2004 came to a halt, and the economic actors consider the outlook to be improving, especially in manufacturing, retail trade and construction. The expectations concerning services and consumer confidence have remained stagnant.

… including the European Union

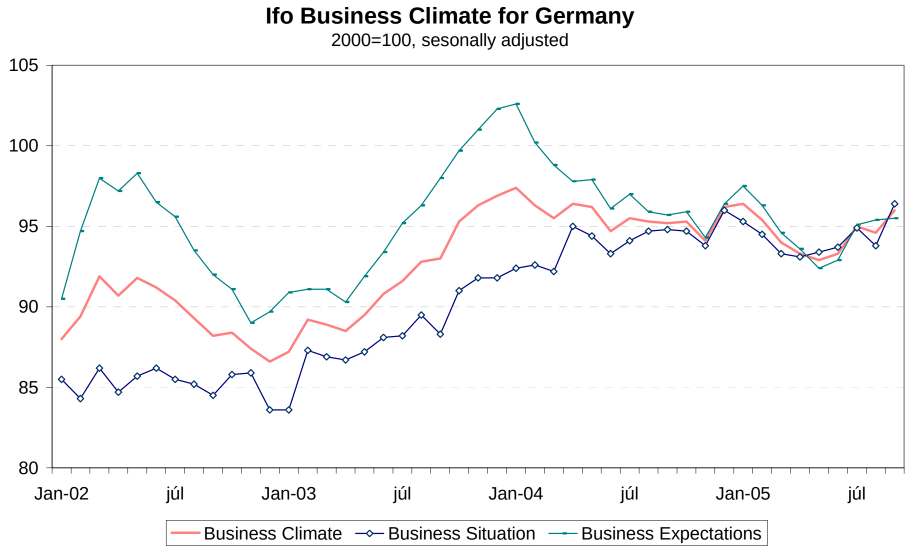


*Business and Consumer Survey, September 2005, EU

Following a temporary decline in August, the economic upswing started in Germany in June resumed in September, and the business cycle index improved by 1.4 percentage points to 96.

The improvement of the German confidence index appears to last

[2] Quarterly Report on the Euro Area (3Q2005)



The comparison of the expectations of the Visegrád countries reveals that expectations regarding the the business cycle in Poland are more favourable that the EU average, the close-to-average expectations of the Czechs and Slovaks appear to be languishing, while the formerly highly unfavourable Hungarian expectations have improved significantly in recent months.

Hungarian expectations concerning the economic cycle have also improved

The events and expectations of the first half-year indicate that growth is likely to continue at a rate below the 2004 figures. Economic recovery, which appears to be picking up since June, is jeopardised increasingly by the radical crude oil price rise and the resulting uncertainty.

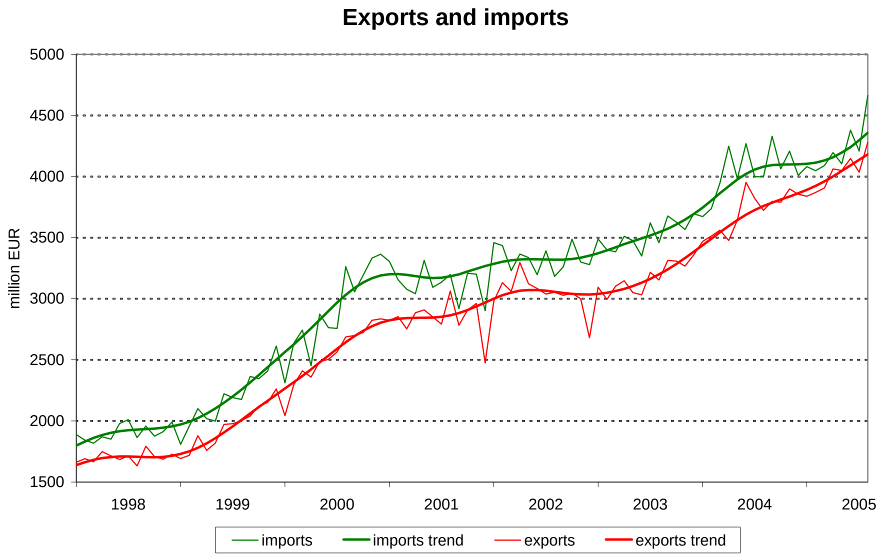
Energy prices and global imbalances represent growing risks

2. Growth factors

2.1 Foreign trade

As a result of the sluggish external expansion, the growth of exports and imports, which had been declining as from the second half of 2004, started accelerating in February 2005. Based on seasonally adjusted trends, the monthly average growth rate of exports increased by 1.0% in the first half-year of 2005, and by 1.1% in July-August. Imports increased faster than exports since February, the monthly growth rate increasing to 0.9% by Q2 and reaching 1.4%, the rate seen in the first half of 2004, by July-August.

Exports and imports accelerating again since early 2005



Outstanding export-import growth in August

In volume terms, **exports** increased by approx. 9% over the base period in the first eight months of the year; the modest 6.7 % increase of Q1 was followed by 11 % growth in Q2. August produced an outstanding export growth of approx. 17%. The volume of **imports** expanded by approx. 3.5% in January-August 2005. The slow growth may be explained by the basis effect: in the first half of 2004: prior to EU accession, import purchases of EUR 850 were brought forward and imported goods of EUR 850 million were released from customs warehouses; adjusting the basis for those effects, import growth was around 6%. In August, imports also increased dynamically, by approx. 14.5%.

Declined trade deficit

The **trade deficit** dropped significantly after March, then it increased slightly in July-August over the declining basis; the deficit amounted to EUR 1881 million in the first eight months, EUR 1060 million less than in the base period.

Detailed statistical figures by product and country are available for the **first seven months**; the structural and country-group export and import assessment below is based on those figures.

The exportation of machinery, energy and cereals increased significantly

In volume terms, exports increased by 8.2%, imports by 1.9% in January-July 2005. The **commodity structure of exports** was dominated by the above-average growth of the exportation of machinery (almost 9% in volume terms), and every sector increased its exports substantially with the only exception of communications technology. Machinery exportation growth was driven by exports of mobile phones, automotive engines, passenger cars and electric machinery. The 5% volume growth of manufacturing was attributable primarily to the expansion of the exportation of pharmaceuticals. The exports of fuels (crude oil products) and of the good products (cereals) produced the most dynamic growth (36% and 11%, respectively, in volume terms).

The **commodity structure of imports** was also dominated by machinery importation, its almost 4% growth originating primarily in the importation of machinery and components from non-EU countries for reexportation and in machinery imports for investment purposes (energy generation equipment). The importation of passenger cars declined as compared to the high basis of the months around EU accession. The importation of food products showed a significant growth (at almost 8%), such imports from Member States increased by 16.5%.

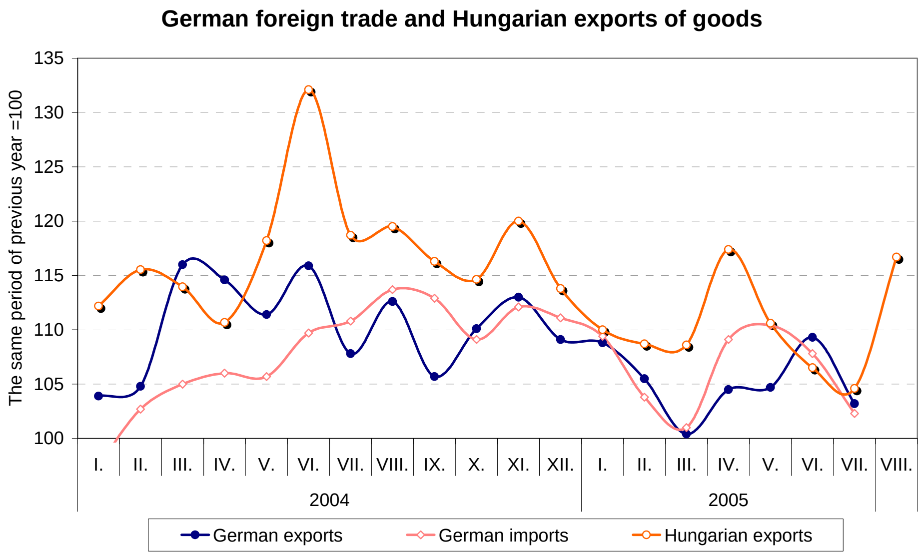
Machinery for reexportation and crude oil dominated in import growth

The terms of trade for Hungary worsened by 1.5% because of the rising fuel prices, causing a price loss of almost EUR 430 million.

Worsening terms of trade

In terms of **country groups,** the volume of exports to the European Union increased by 3.5%, our exports to the EU15 remained stagnant; within that, exports to Italy, Austria, Spain and Finland (as compensation for the Gripen aircraft imports) increased while export to Germany declined. We assume that within the major (17%) export growth of August, our exportation into the EU15 countries also increased. Our export trends show a close correlation with the import demand of Member States, in particular Germany.

Exports to the EU15 stagnating



Our exports into new Member States have been increasing continuously at a rate significantly above the average since 2003 (by 25-30% in volume terms). That trend continued in the first seven months of 2005, the volume of exports growing by 35%. In respect of countries outside the European Union, the volume of both exports and imports increased at rates exceeding the average: by 27 % and 20 %, respectively. Exportation into extra-EU countries in Europe (Russia, Romania, Croatia, Bulgaria, Turkey) increased by 38 % in euro terms; our exports into the US also expanded significantly (by 18% in euro terms). The importation for export purposes from Asian countries (Japan, China, Honk Kong) increased by 4.0% in euro terms. As a result, our commodity trade became more diversified, the share of EU15 countries

Intensive expansion of exports continued into new Member States and non-EU countries within Europe falling from 73% of our exports to 67%, and from 65% of our imports to 59% as compared to the base period.

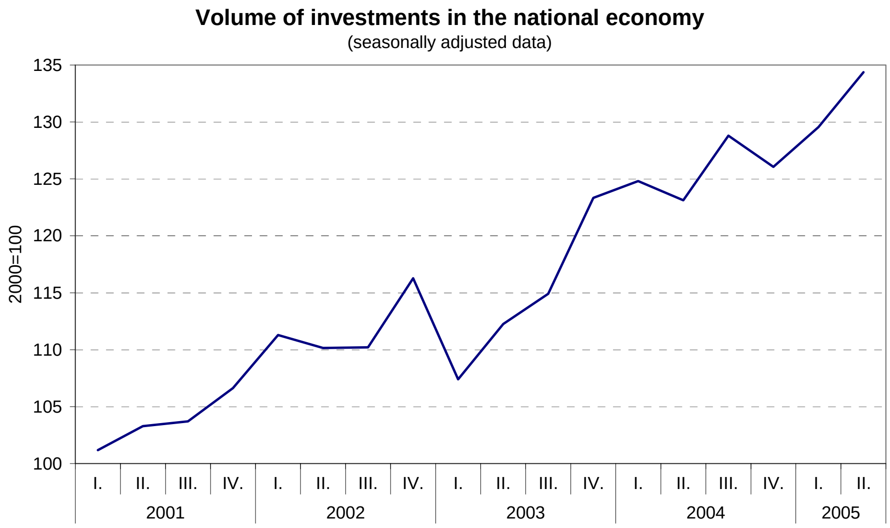
Uncertain external expansion is a risk

In 2005, the main risk lies in the external economic environment as our export growth hinges primarily on the import demand of the Member States. The diversification of our export markets can be interpreted as a favourable sign. Based on the increasing import demand of Member States (particularly Germany), export prospects may be even more positive than originally expected. Based on the monthly trends evolving upon the acceleration of turnover in August, the export growth is very likely to be around the high edge of the projected 9-11% range, which translates into the current 1-1.1% monthly growth. Import growth is expected to pick up in the remaining part of the year because of the low base and the intensive monthly growth rates since Q2; annual export growth may be around the low edge of the 7-9% range. The trade deficit is expected to be about EUR 3.3-3.4 billion, which corresponds to a drop of EUR 500-600 million from the year 2004 level.

2.2 Investment

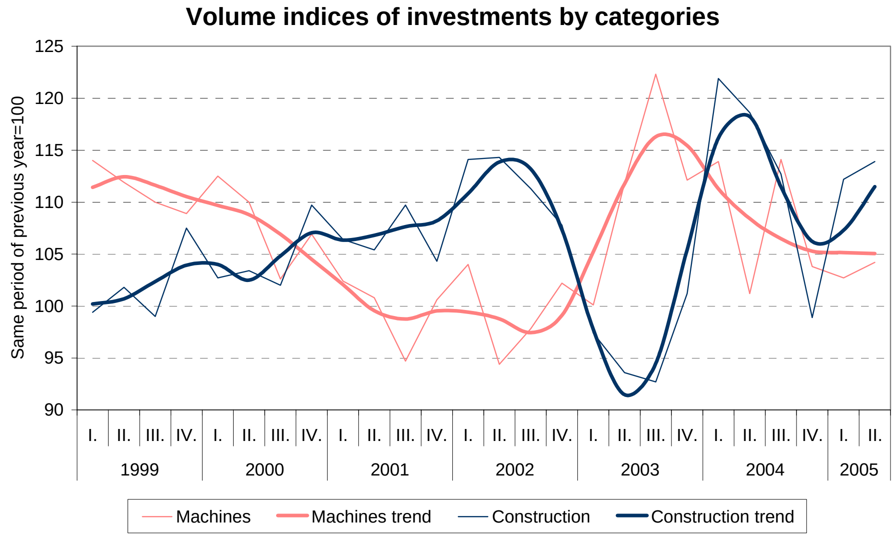
Almost two-digit growth

The volume of investment in the national economy expanded by an outstanding 9.4% in Q2, and by 8.3% in the entire first half-year. After the last quarter of 2004, the investment momentum has remained unbroken and has accelerated quarter by quarter.



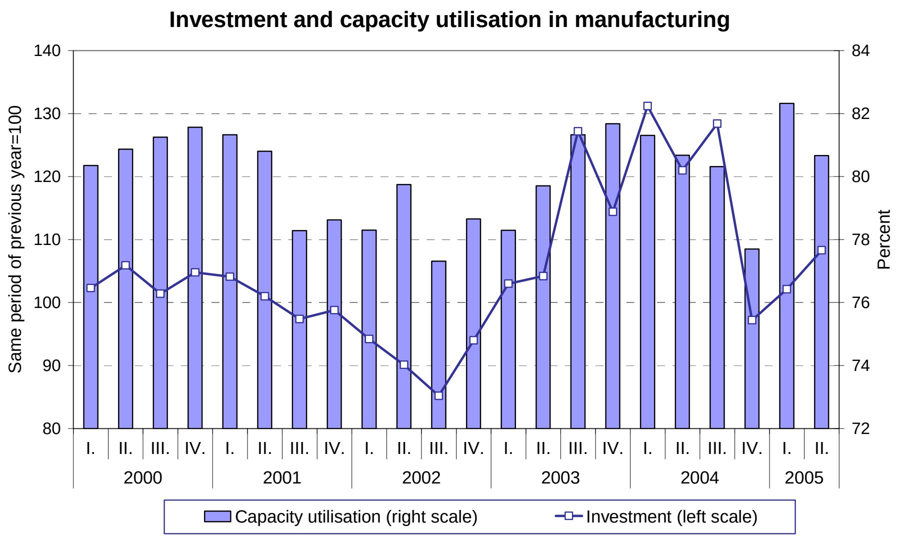
Improving investment structure

The structure of investments has shown an improving trend. Although because of the high-volume motorway construction projects construction investments continue to dominate (13.9%), investments in machinery picked up again (4.2%) after a more modest performance in the previous quarter.



Manufacturing investments picking up

The expanding trend of manufacturing investments signal the continuation of the economic upswing. Despite the over 20% growth a year before, the growth rate of the sector remained robust (8.3%) in Q2 this year. Ever since the autumn of 2003 - apart from a decline in the last quarter of 2004 - the capacity utilisation in the manufacturing sector has fluctuated between the high values of 80-82%,. In Q2, however, capacity utilisation was higher-than-average in the machine industry (83%), which has a large weight, and in the manufacture of other non-metallic products (84%); this may have a positive effect on the investment trend in the second half-year.



The strong manufacturing investment performance is accompanied by high-volume infrastructure investments (motorway construction). As a result of the ongoing works on 14 sections and the completed constructions, the transportation sector produced a growth of over 40%. The investment growth in the also large weighted real estate activities sector - which includes housing contruction - was somewhat lower than average (5.2%), but remained robust.

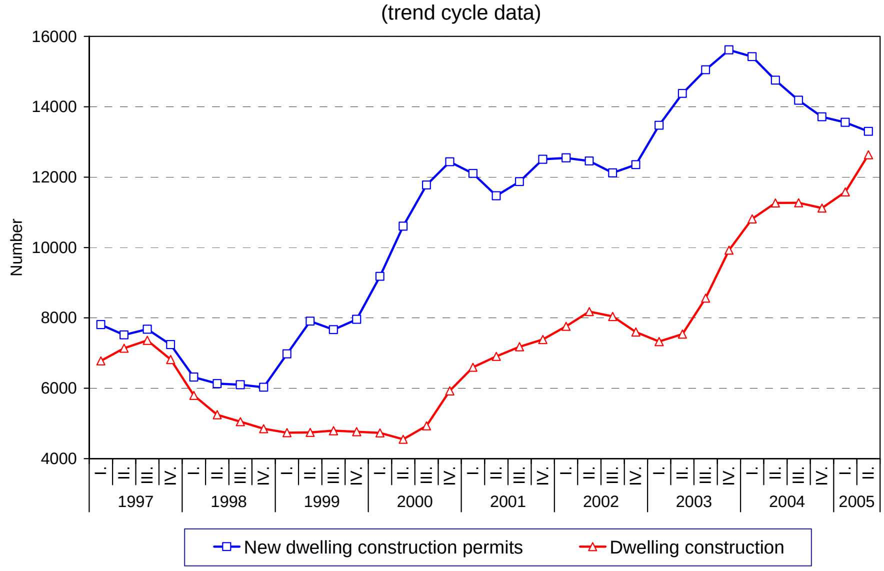
Motorway construction is stepping up

In the first half-year, 11 % more dwellings were put to use, while the number of construction permits issued was 10% behind the figure one the year before. On the other hand, partly because of the altered terms of borrowing, housing construction has shifted towards single-room dwellings, thus the average floor area fell by 6 m^2.

Increasing number of dwellings, shrinking floor space

Based on the downward trend of construction permits and taking into consideration the average construction period of five quarters, the number of dwellings put to use is likely to decline in the second half-year. As a result of the two-digit growth of the first half-year, the record of 2004 may be repeated in the whole of 2005, with 42-44 thousand new dwellings constructed.

Dwelling construction and construction permits
(trend cycle data)



In our previous flash report we forecasted investment growth of 5-7% for the whole of 2005. Based on the positive figures of the first six months, however, it appears justified to amend our forecast upwards to 6-8%, and actual output is likely to be closer to the high edge of the range.

Stronger-than-expected growth in the whole of 2005

2.3 Retail trade, consumption

In the past three months, the volume of **retail trade turnover** produced a steady growth. The sales volume adjusted for the calendar effect and without the trade of motor vehicles and automative fuels was 5.7% higher in May, June and July than in the corresponding months of the previous year. In aggregate, turnover increased by 4.9% in January-July.

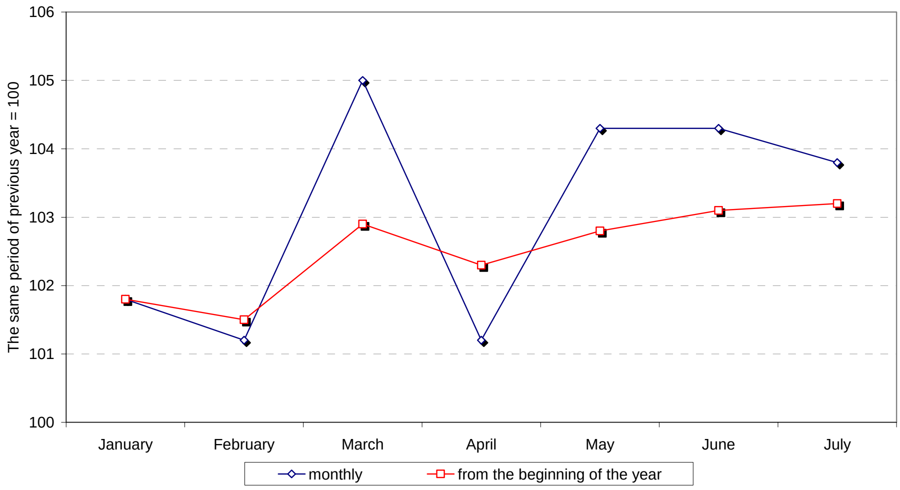
Steady turnover growth in recent months

The turnover of motor vehicles and vehicle components stopped its decline in the past two months, but even so, the aggregate turnover of the first seven months was 2.3% below the corresponding period of last year. The total turnover, without adjustments, increased by 4.9% at current prices, or by 3.2% at constant prices.

Substantial increase in the turnover of catering

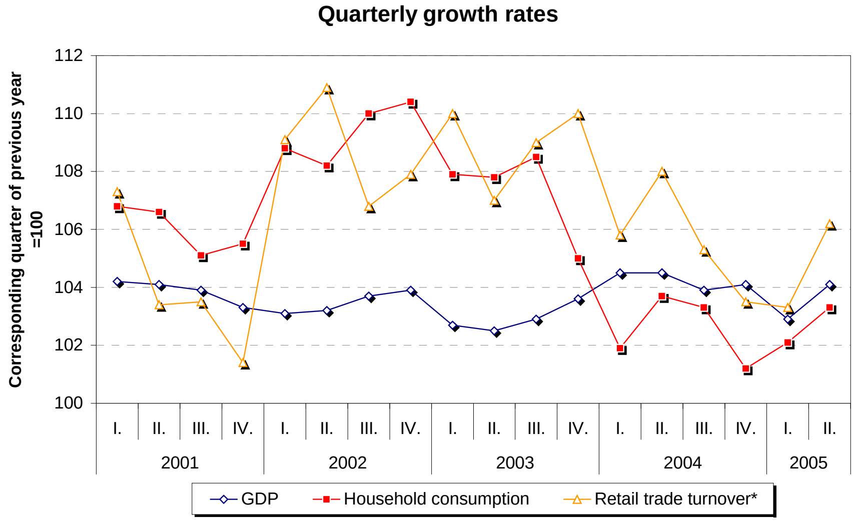
The turnover of catering units not included in retail trade turnover expanded at a significantly faster rate, by 7.8% in seven months In all probability this was partly attributable to expanding domestic tourism.

Volume indicies of total retail turnover in 2005



Accelerating consumption growth

In Q2, the growth of the **consumption of households** accelerated: its volume increased by 2.1% in Q1, 3.3% in Q2 and 2.7% in the entire half-year. The acceleration was due to consumption expenditures, with the growth of in-kind social benefits slowing down in Q2, partly due to the more stringent conditions of financial management of budgetary institutions.



* Without the trade of vehicles and fuels, adjusted for calendar effect

Taking into consideration the seven-month figures of retail trade turnover and the half-year figures of consumption, we reckon with an annual growth of household consumption of approx. 3%.

2.4 Output

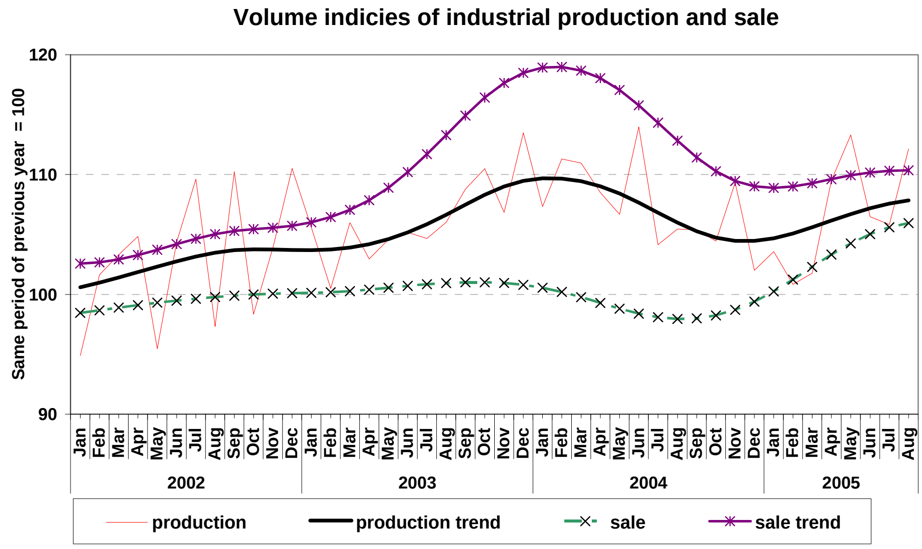
Industrial output growth accelerated in Q2…

In the first eight months of the year, **industrial output** increased by **6.7%.** The growth rates varied considerably from month to month, the poor start in Q1 was followed by more dynamic growth in Q2, resulting from favourable external market opportunities as well as the intensive growth of domestic demand.

same period of previous year = 100

2005	Output		Sales		
		of which: manufacturing	total	of which: domestic	export
Q1	102,0	102,1	102,9	100,9	104,8
Q2	109,7	110,4	109,9	105,4	114,2
july	105,8	106,1	105,9	103,2	108,6
august (preliminary)	112,1				

Because of the uncertainties created by summer vacation time, it is not expedient to draw conclusion from the July and August figures.



Both the trend and twelve-month ex post indices of output have been increasing monotonously for three months, reaching 8% and 6%, respectively, by August.

… its output trend is increasing…

This year, August contained two working days more than last year, therefore the index adjusted for working days (6.9%) is significantly below the unadjusted growth of 12.1%. The index adjusted for working days and seasonal effects declined by 1.5% as compared to the previous month.

… its dynamism enhanced by the additional working days in August

Output growth continues to be driven by export sales. Of the two sectors responsible for close to two thirds of manufacturing exports, the exports of *electrical and optical equipment* were up by 16% in eight months, that of *transport equipment manufacturing*, by 10%. Between January and August, the exportation of electronic components, communication engineering equipment and engines and components for road vehicles produced the most dynamic increase. The export sales of the *manufacturing of machinery* also increased by 10% between January and August, with heavy monthly fluctuations. Export sales of the *light industry* sectors declined.

Manufacturing exports expanded by 10% in eight months

In the area of sales, the upturn in domestic sales was a new trend this year. The *manufacture of electrical and optical equipment* increased its domestic sales by 26% between January and August; within that, the sale of electronic components more than doubled. Increased domestic demand for the (mostly semi-finished) products of *transport equipment manufacturing* resulted in 24% turnover growth in aggregate. The manufacture of *other non-metallic mineral products*, which has little weight in the manufacturing output, increased its domestic sales by 13% in eight months, because of the energetic progress of motorway construction. The volume decline of the domestic sales of the *food product sector*, which targets primarily the domestic market, continued in August, thus it was 3.5% lower in the first eight months than in the

Domestic sales expanded by 4% in eight months corresponding period of the previous year. The classic *light industry* sectors also struggled with a marked drop in domestic demand.

Productivity growth below the first half-year of 2004

In the first half of this year, the productivity of industry (GDP/persons employed) was close to the average of the national economy (3.5%), that of industry being 3.7%, that of the manufacturing sector, 3.8%. This means that the capacity of industry to produce added value declined.

The volume of new orders declining in August

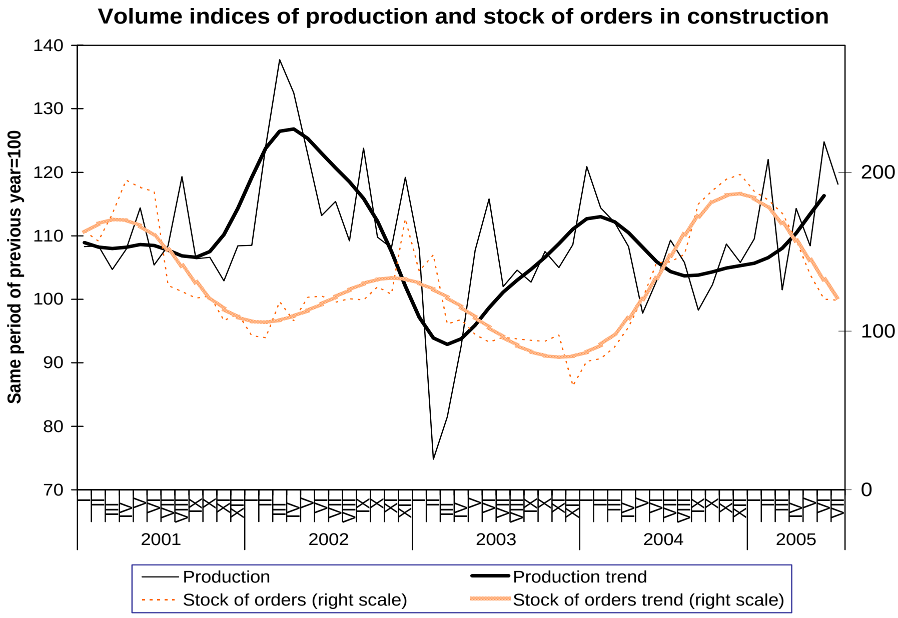
In August, the volume growth of total new orders was 2% below the previous year figure. New export orders declined by close to 3%, which is explained by the 16.5% drop in the new orders of the *manufacturing of electric and optical equipment.* (On the other hand, export demand increased for the products of the *paper industry* by 60%, the *machine industry* by 50%, *metallurgy* by 17%, the *chemical industry* by 14%, and *transport equipment manufacturing* by 13%). The volume of new domestic orders increased by 1.4%, within the *manufacture of electric and optical equipment* went up by 33% and the *transport equipment manufacturing* by 10%. (Similarly to output, drawing conclusions from the summer months trends from the order book would be precipitate.)

For the whole of 2005, growth rate of 6-8% is still expected

Having considered the uncertainties of summer months in respect of new orders, taking into consideration the improving business confidence indices but ruling out an extraordinary international downturn in the business cycle, it is reasonable to conclude that demand for the products of Hungarian industry will continue to be perky in the remaining months of the year. Therefore we continue to reckon with an output growth around 6-8% for 2005.

Vigorous growth of construction output

Primarily as a result of road network development projects, the output of **construction** increased by 15% in the first seven months. As a new phenomenon, the construction of buildings also picked up in the past two months. Both the trend and twelve-month ex post indices of the sector have increased, reaching 18% and 9.5%, respectively, in July.



The volume of new contracts in July exceeded the low basis of last year by 9%, within that, the new contracts for *other structures*, which include infrastructure development projects, were up by a mere 1%, while contracts for *buildings* increased by 19.5%. The volume indices of the period-end order book declined month by month, but they were still 19% higher than in July last year.

Increase of the volume of new contracts

Taking into consideration the slow-down of the growth of the order book, construction output is expected to be around 10% this year.

The harvested volume of eared cereals exceeded the average for the 2000-2004 period by 17%; still, it was 15% less than the record harvest of the pervious year, and its quality is also considerably poorer. Experts expect 7 million tons of maize, which, as in the case of eared cereals, is less than in 2004, but it exceeds the average of previous years. According to the survey of 1 August, livestock has continued to decrease below the previous year level, with the exception of sheep.

In the first seven months of the year, the producer price level of agricultural products was 6% below last year’s figures, while expenditures of agriculture declined by a mere 1%.

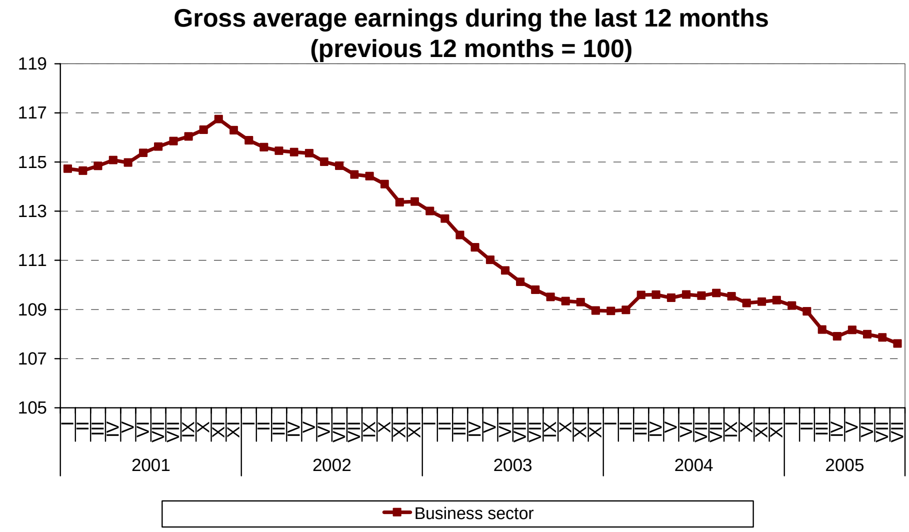
The output of the **transport sector** in the first half-year increased significantly as a result of the vigorously expanding logistics operations and the dynamic motorway construction projects: the volume of goods transported increased by 24% or, in freight ton kilometres, by 57%. As a result of the recovery of tourism, the turnover of international passenger transportation increased by one quarter, within that, air transport produced a 56% growth.

Substantial increase in freight and passenger transport

2.5 Labour market

7.3% gross average earning increase in the national economy

According to CSO figures, the monthly average nominal earnings of persons employed full time in the national economy rose by 10.4% in the first seven months of 2005 over the corresponding period of 2004. That figure is distorted by the change of the rules governing the payment of the additional one month salary in the budget sector in 2004; after adjustment for that factor, growth was 7.3%. This is in line with the 6-8% gross average earnings increase projected for the year.



7.2 % growth in the business sector

In the entire business sector, the rate of growth of the wage outflow was lower than in the previous year. In the first seven months of 2005, gross average earnings increased by 7.2%, at the expected rate, over the corresponding period of 2004. Within the branches of the sector, financial activities (9.4%), hotel services, catering (8,6%) as well as transportation, warehousing, postal services and telecommunication (8.8%) produced an above-average growth.

In the budgetary sector, the CSO showed a gross average earnings increase of 16.9%, which is distorted by the modification of the rule on the payment of the one-month additional salary. After adjustment for that factor, gross average earnings in the sector increased by 7.7%. Within the budgetary sector, every branch produced a gross average earning growth around the average, with the exception of health care (6.7%).

4.8 % real wage increase in the national economy

In 2005, net earnings in the national economy increased at a faster rate that gross earnings due to changes in the PIT Act. Because of the abolition of the medium rate of the three-tier tax system effective in 2004, the tax burden was reduced primarily for taxpayers formerly falling in the medium or high brackets. In the first seven months of 2005, net average earnings increased by 8.6% over the corresponding period of 2004 in the business sector, and by 8.7% in the whole of the national economy (net of the effects of the one-month additional salary). This corresponded to a 4.8% growth of real earnings in the first seven months. The above figures are in line with the 8-10% net average earning growth and 4-6% real wage increase projected for the whole of 2005.

Outstanding real wage growth in Hungary by regional standards

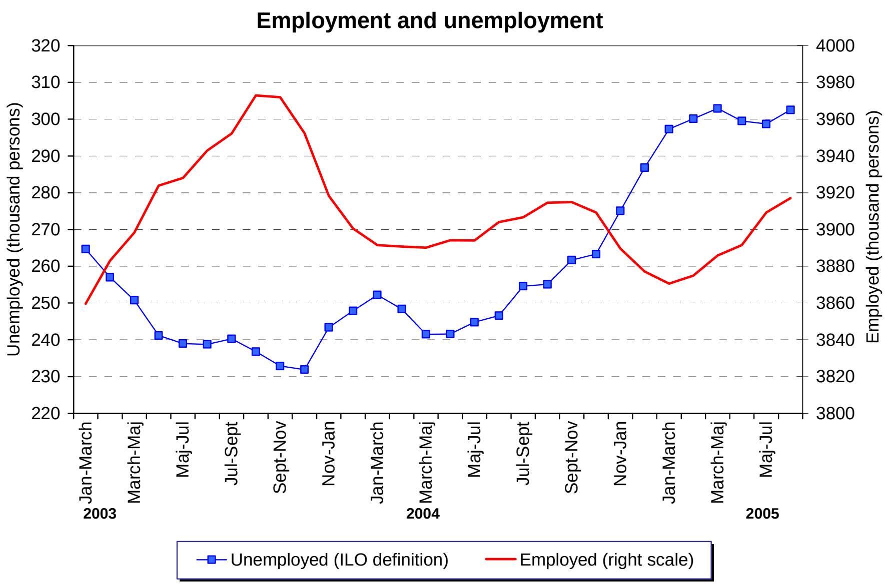
Of the Visegrád countries, only Slovakia produced higher real earnings growth than Hungary (at 6.4%) in the first half of 2005. In the first six months of the year, real earnings increased by 3.9% in the Czech Republic and by 0.3% in Poland over the corresponding period of 2004.

Stagnating number of employees

According to the institutional statistics of the CSO, the number of persons employed by businesses with at least five employees and by budgetary and social insurance institutions, stagnated in the first seven months of 2005; thus 2 million 786 thousand persons were employed on average during this period. Within that, the headcount of the business sector increased by 0.3%, that of the budgetary sector declined by 1.3%.

The number of employed persons has been increasing since April

A slightly more favourable situation is revealed by the household labour survey of the CSO, the coverage of this is wider than that of the institutional statistics as it also includes employees of firms with less than five employees and persons working outside employment relationships. Accordingly, in June-August 2005 there were 3 million 917 thousand employed and 302.5 thousand unemployed persons on the labour market. The number of employees declined by 13 thousand (which is within the error-margin of the sample), while the number of unemployed rose by 55.9 thousand over the corresponding period of the previous year. The more positive picture results from the trend of recent months, which indicates that the number of employed persons has started a steep rise, while the number of unemployed effectively stagnates, with minor fluctuations.



Increasing activity on the labour market

On the whole, the number of economically active persons increased by almost 70 thousand in the past year, while the number of economically inactive persons declined by essentially the same number (67 thousand), thus the increase of unemployment is effectively explained by the re-appearance of the inactive on the labour market. The participation rate for the period under review improved by 0.8 percentage points (54.6%), the employment rate by 0.1 percentage point (50.7%) over the corresponding period of 2004. The data derived from the household labour survey of the CSO must be treated with some caution, taking into consideration the reliability of sampling.

Unemployment rate is rising, but still low by international standards

The Eurostat regularly publishes harmonised unemployment rates; for Hungary its value in August was 6.4%. This is 0.6 percentage points higher than in the corresponding period of 2004, but in international comparison it continues to be substantially lower than the corresponding figures of the Euro area (8.6%) and the EU-25 (8.7%). From among the new Member States, only Cyprus (5.5%) and Slovenia (5.8%) had lower rates, while all Visegrád countries had higher unemployment (Czech Republic 7.7%, Slovakia 15.2%, Poland 17.5%).

By year-end, the unemployment rate calculated from the labour survey is expected to decline to 6.8-7%. In the entire year, the employment rate is expected to produce a slight improvement and the participation rate a more significant improvement.

2.6 Gross domestic product

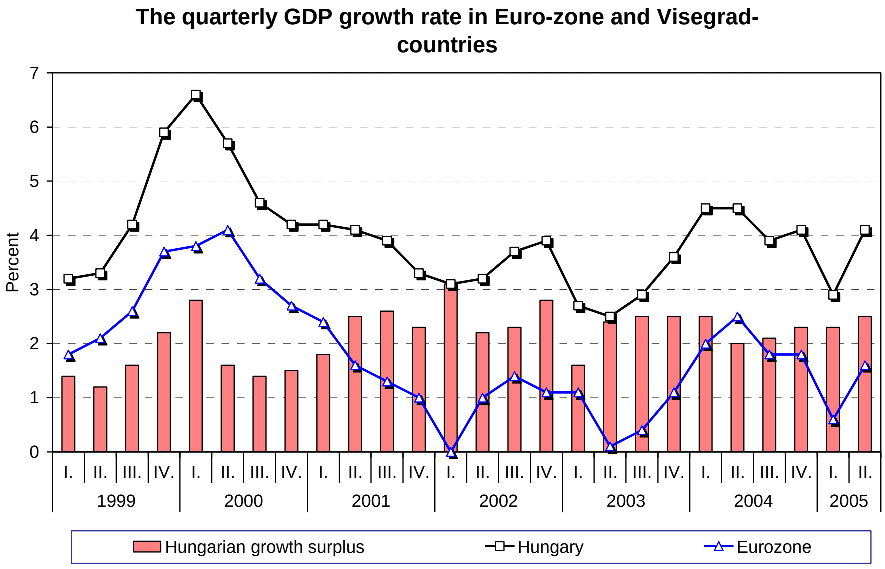
Accelerating growth

Following a more moderate performance in the first quarter, economic growth rose again to above 4% in Q2. In the whole of the first half-year, the growth rate was 3.5%, while the growth rate adjusted for the leap day effect, which gives a more realistic picture of actual economic trends, is substantially higher (3.9%).

Since 2001, our growth surplus over the euro area countries of over two percentage points appears to be stable. This favourable performance is highly conducive to fast convergence to the average development level of Member States.

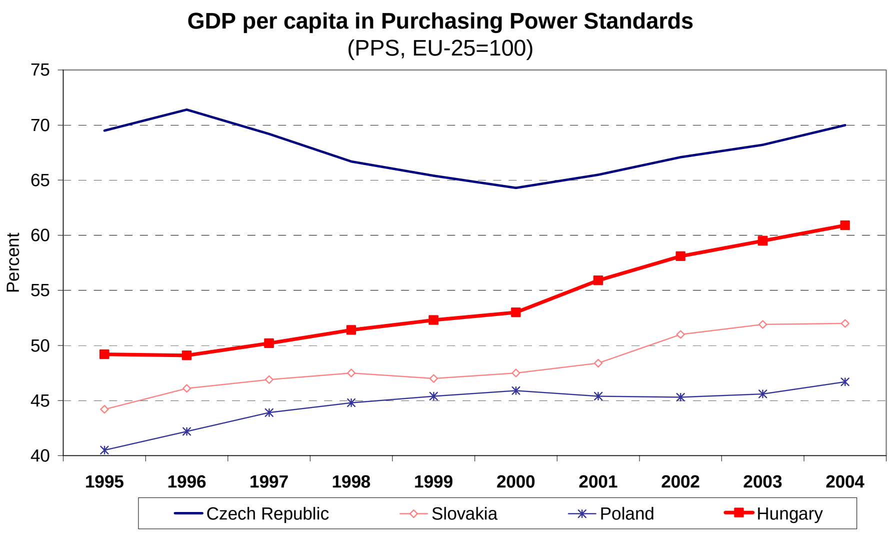
> In early October the CSO modified the year 2002-2004 GDP figures, because, in compliance with Eurostat requirements, it switched to the new methodology for the settlement of the financial intermediation service indirect measurement (FISIM). Financial intermediaries, on the one hand, charge fees directly to consumers for banking services, and on the other hand, they extend other services without explicitly charging fees. In case of indirect fees, the consideration for the service is recovered by the financial intermediaries from the difference between the lending and borrowing interest rates. In the past, the FISIM items had not been allocated to sectors and branches actually using the services, instead, they were recorded in a nominal sector, as services provided to the entire national economy.
>
> As a result of the new methodology, both the GDP figure at current prices and its volume growth became higher in the affected years. While growth was 2.9% in 2003 and 4.2% in 2004 without the allocation of FISIM, the new methodology changed those figures to 3.4% in 2003 and 4.6% in 2004. The year 2004 figures were also altered by the fact that the CSO replaced the previous, preliminary GDP figure with a new one reflecting a higher degree of data processing (second disclosure). The methodological change and the more detailed figures of last year did not change the GDP growth structure

substantively: growth was still driven by exports and investments. In 2004, household consumption rose from the previous 2.5% to 3.1%, and the growth rate of investments and of exports also increased significantly. Gross capital formation rose by 8.4%, instead of the previous 7.9%, and export by 16.4% rather than 14.9% in 2004. The CSO has not yet published the quarterly breakdown of annual figures, therefore those figures could not be used in the quarterly analyses.

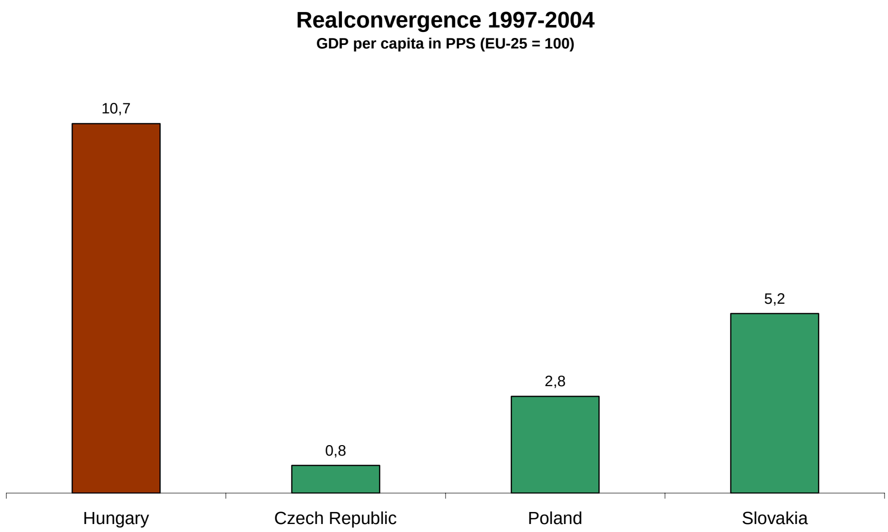


In the past ten years, among Visegrád countries Hungary had the fastest and most balanced convergence process to the EU average. The balanced, stable approximation process was attributable primarily to the stabilisation package implemented in 1995. From that time on, the Hungarian economy started along a course of fast convergence. No decline occurred even in the year of the adjustment, unlike in other Visegrád countries, where two- or four-year periods of decline was experienced following the stabilisation programmes. In the Czech economy that decline occurred in 1997-2000, while in Poland and Slovakia, in 2001-2002 and 1999-2000, respectively..

Hungary's convergence is the fastest of the Visegrád countries

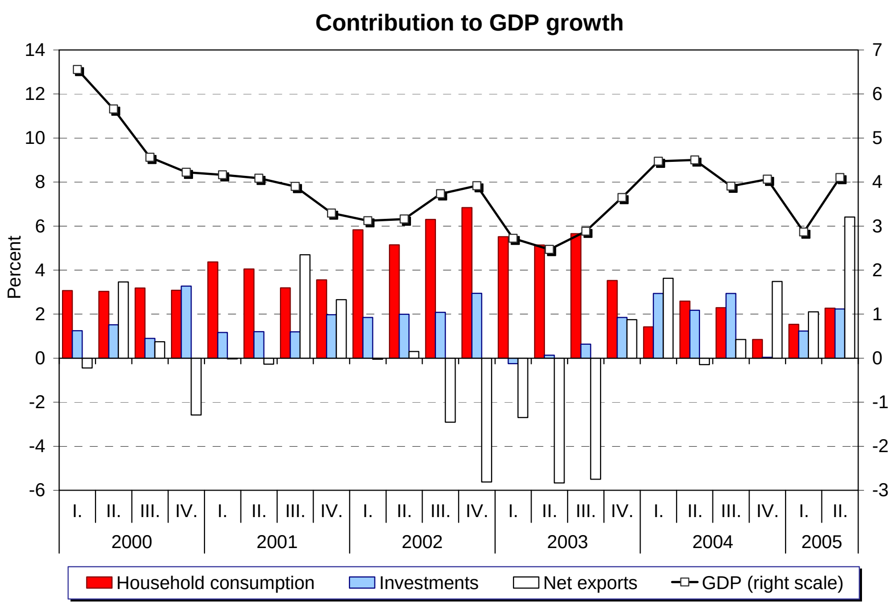


Between 1995 and 2004 the Hungarian economy worked off almost half of its lag behind the Czech economy in ten years, and almost doubled its lead over the Slovak and Polish economies.



The structure of growth remains sound

Growth occurred in a sound structure. It continues to be driven by dynamic investment activity and outstanding export performance, while household consumption has expanded at a rate below GDP growth. As a result of the economic policy shift started in 2003, this favourable structure has been continuously perceivable for 8 quarters now, which has a key importance in the long term sustainability of economic growth.



Dynamic investment, sustainable consumption growth

The growth of household consumption, which is significantly below GDP growth, appears to have stabilised science early 2004. The 3.3% consumption growth of Q2 is slightly higher than in the previous quarter, and the pick-up of retail trade turnover also signalled this acceleration. On the other hand, the saving propensity of households also increased in

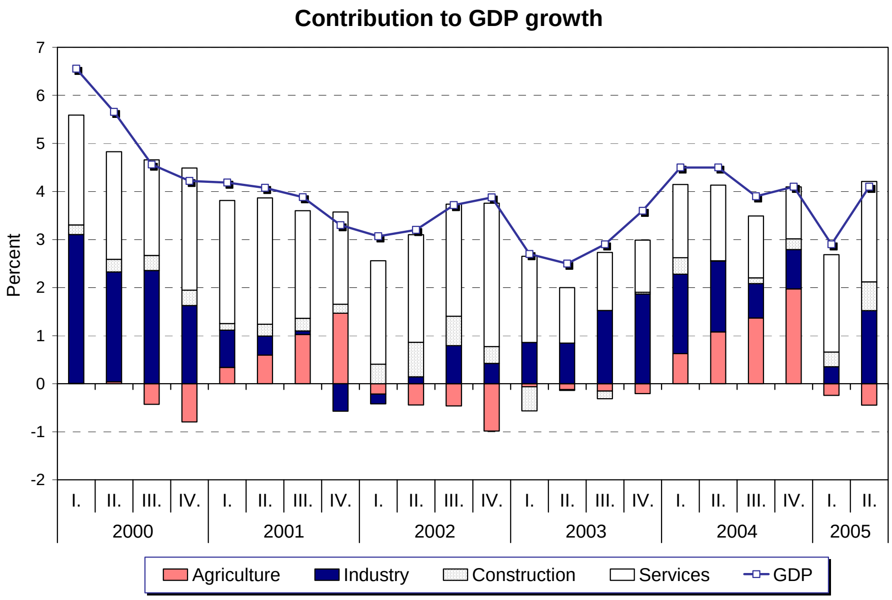
Q2, thus the increase of their consumption was moderate despite the positive earnings prospects. The growth rate of gross capital formation came close to 10%. Both government infrastructure investments and business investments expanded significantly.

Considerable export expansion

The growth rate of the foreign trade of goods and services followed a favourable course in Q2. Export growth accelerated to the two-digit figures again, while import growth, which had also been two-digit in the past two years, temporarily slowed down significantly. This was mostly due to the high basis before our EU accession last year. Net exports, which have not been this high since the first quarter following the year of stabilisation, contributed most to economic growth (6.4%).

Agriculture and non-market services slow down growth

The structure of economic growth is favourable also on the production side. The value added by both the non-service sectors (5.2%) and of market services (4.8%) increased significantly. The output of agriculture, however, declined by 10% due to the high basis, while the value added by non-market services increased by a more moderate rate due to the budgetary austerity measures. Without those two branches, GDP growth would reach 5.5%, which testifies the dynamism of the Hungarian economy.



Higher-than-expected growth

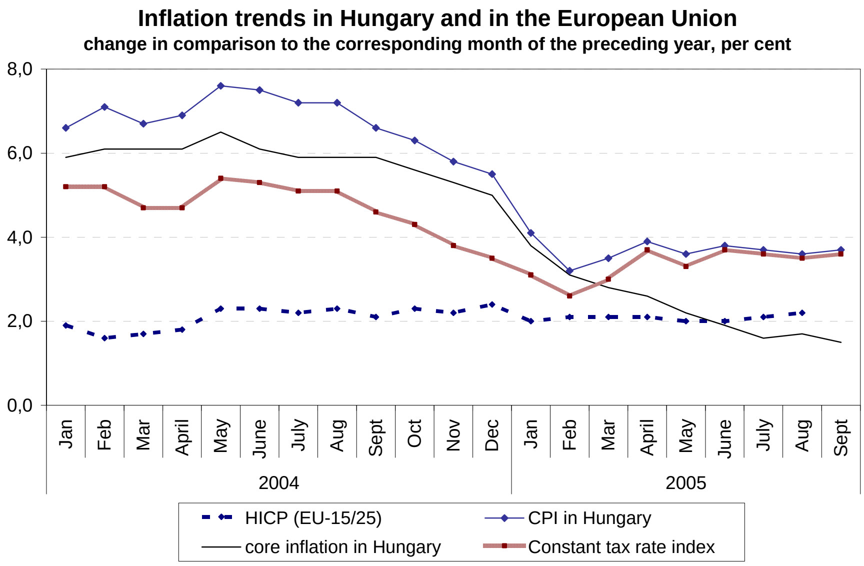
Based on the favourable processes present both on the supply and demand sides, **GDP growth** is expected to be around the high edge of the 3.5-4% range this year.

3. Inflation

Lower than projected inflation

In the past year, the Hungarian economy adopted a more favourable inflation course in light of the actual figures of the first three quarters; the **year 2005 inflation** is likely to be **around 3.7%** as an annual average. Risks are essentially symmetrical.

Decelerating inflation is attributable primarily to the slowdown of wage increases, the continuously strong exchange rate and the effects of EU accession on competition regarding both the supply side and the commercial sector, which is difficult to quantify but is still perceivable. These processes are hindered by the price increase of fuels and energy in international markets. The effects of the latter are only partially reflected in the Hungarian price index because of measures taken respecting regulated prices.

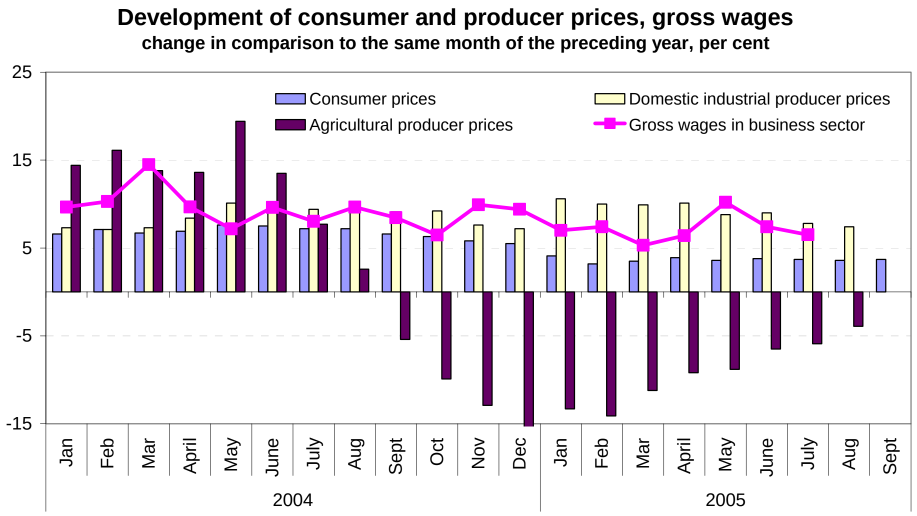


The decline of the core inflation rate, started in mid-2004, continued in 2005

The comparison of the Hungarian price index, net of tax changes, with the European trend reveals that even though the energy price increase did effect the Hungarian economy, the forces of disinflation proved stronger. It is worth noting that the core inflation indicator (which is adjusted, inter alia, for the direct effect of energy price increases) sank below 2%, a level corresponding to effective price stability..

On the **supply and costs sides** the slowdown of wage increases, being increasingly aligned to the altered inflationary environment, certainly reinforces steady disinflation. As another argument for long-term disinflation, the decelerating expansion of household consumption, the slowdown of wage increases on the supply and cost sides and the relaxation of bottlenecks on the labour market bring about the deceleration of price increases of market services. In addition to the strong disinflation of the tradable sector, this also results in the deceleration of non-tradable inflation.

International and domestic producer and commercial competition continues to be keen, which creates a favourable inflation environment by checking producer prices. The moderating effect on prices of increasingly firm competition has further reduced the domestic inflation of consumer and clothing articles, and kept it below 2%, effectively meaning price stability. This is also true for an increasingly wide range of processed food products. The low price level of agricultural products that emerged in the past period moderates the prices of unprocessed food products.



The wage growth rate gradually slowing down

High oil prices have direct inflationary effects on energy producing sectors and fuels. Furthermore, it exerts continuous inflationary pressure on other sectors of the economy, but as a result of keen competition there is limited inflationary ripple effect. This is further enhanced by the continuously improving energy efficiency of the Hungarian economy. Additional effects of increasing energy prices may present themselves next year.

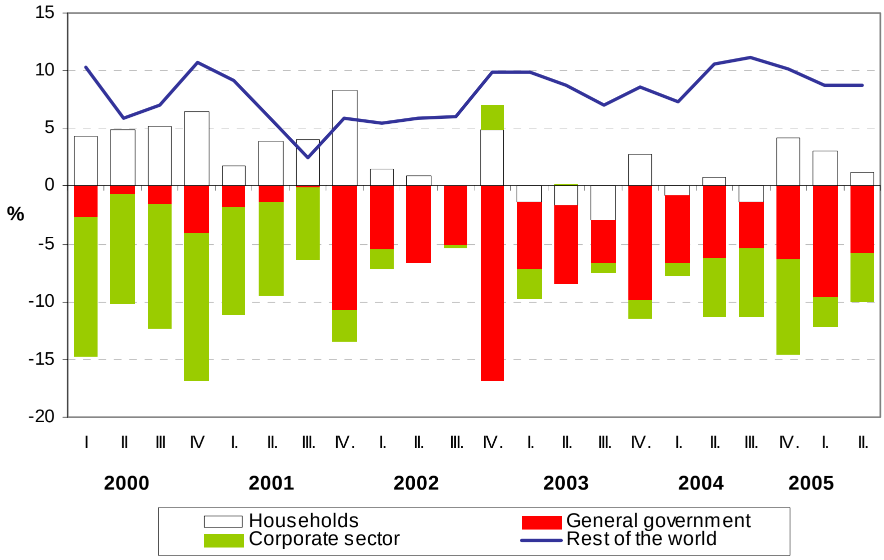
4. Income and financial developments

4.1 Equilibrium

The external financing requirement of the economy as a percentage of GDP declining

Similarly to the current account, the financial accounts also indicate that the external financing requirement of the Hungarian economy, though still high, has been falling in 2005 as compared to the previous year level. The external equilibrium indicator, from the financial account angle, corresponded to -8.7% of GDP in the first half-year. The improvement was facilitated mainly by increased household savings because the general government deficit continued to expand fast up to June as a result of seasonal and non-recurring factors, and the financing need of businesses continues to be substantial. The financing need of non-financial enterprises amounted to 4.9% of GDP in the first half of 2005, as opposed to 5.2% in last year (financial and non-financial enterprises together: 3.4%).

Financing requirement / capacity of sectors (in per cent of GDP)



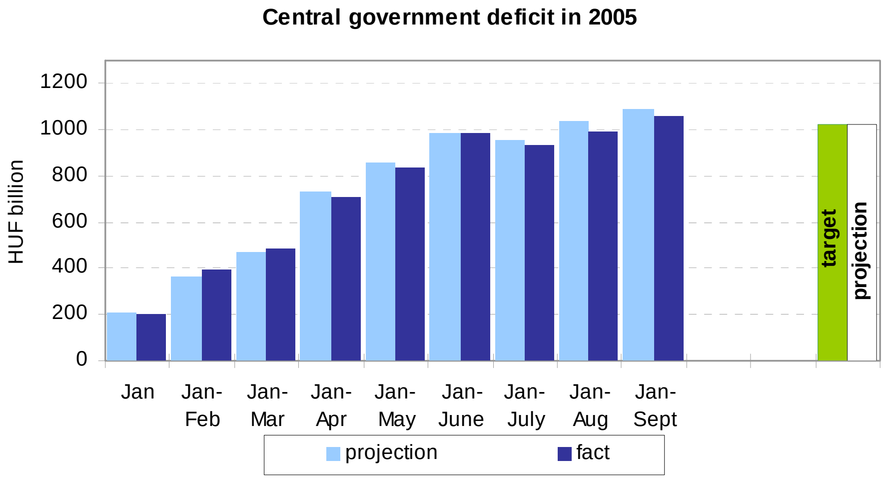
Household savings, without private pension fund savings, may almost double over the 2004 level for the entire year, reaching approx. 1.5% of GDP. The general government deficit will be slightly higher than last year, the financing need may reach 6.1% of GDP. The financing need of the corporate sector will be similar to the first half-year levels, but as a result of growing household savings, the external financing need may fall below 8% of GDP. (The forecast takes into consideration the external equilibrium indicator being improved by the EU transfers coming in through the capital account.)

4.2 General government

Based on the cash data, the deficit of the central government (central budget, social security funds and extra-budgetary funds) reached HUF 1059.5 billion (103.6 % of the annual appropriation) in the first three quarters. A deficit of HUF 780.9 billion (111.6 % of the annual appropriation) was generated in the central budget, and HUF 320.7 billion in social security funds (94% of the appropriation), while the balance of the extra-budgetary funds showed a surplus of HUF 42.1 billion.

Lower-than-expected cash deficit in Q3,...

In Q3, the deficit turned out to be smaller than the monthly reviewed projections. The collection of tax revenues (primarily of VAT) developed more positively than expected, and on the expenditure side the net expenditures of budgetary institutions and chapter-managed appropriations (without expenditures covered from own revenues or from EU transfers) declined more than originally projected.



Because of the higher expenditures early in the year (one-month additional salary, agricultural subsidies, etc.), the net expenditures of budgetary institutions and of chapter-managed appropriations are still above the time proportionate level (by end-September 78% of the appropriation has been spent) but since June, the effects of the reserving and residue blocking obligations have been apparent and monthly expenditures have noticeably fallen.

...effects of measures are perceivable

Even though the cash deficit of the central government exceeded the annual appropriation by the end of September, taking into consideration the surplus expected for December, the annual budget is not expected to depart from the appropriation.

Unlike cash data, the accrual figures have changed significantly since the publication of the last Flash Report. Taking into consideration the position of Eurostat, two substantive adjustments have been made: the uniform treatment of the one-month additional salary of the public sector and the reclassification of revenues and expenditures relating to the motorway construction have added to the ESA95 deficit of the government sector.

Substantially modified ESA figures due to...

The adjustment of payroll expenditures on an accrual basis had a major effect mainly on the year 2004 deficit. The Eurostat requested the Hungarian statistical authorities to "post back" the additional salaries paid this January to 2004, thus last year's deficit increased by 1.1 percentage points as a percentage of GDP. The deficit of 5.4% of GDP resulting from the reviewed data continues to testify to the implementation of a substantial adjustment of 3 percentage points as compared to 2002.

... the accrual-based adjustment for wage expenditures...

The reclassification of the motorway construction worsens this year's expected ESA deficit by almost 2% of GDP. Originally the revenues from the transfer of previously completed motorway sections would have reduced government investment expenditures, thus also the deficit, as

... and the reclassification of the motorway construction

"negative investment", similarly to the sale of tangible assets, in the accrual-based accounts. According to the preliminary position of Eurostat, this transaction cannot be regarded as sale; consequently, the MoF reckons with no such revenues for the calculation of the ESA deficit. (The deficit is further increased by the absence of reimbursement for the investment costs of the sections expanded.) Taking into consideration the motorway adjustment as well as potential risks both on the revenue and expenditure sides, the expected ESA deficit for this year (including private pension funds) may reach, instead of the targeted 3.6%, 6.1% of GDP.

as a percentage of GDP

	2001	**2002**	**2003**	**2004**	**2005**
Deficit (with pension funds)	3,5	8,5	6,5	5,4	6,1
Effect of pension reform	*0,7*	*0,7*	*0,9*	*1,1*	*1,3*
Gross public debt	52,2	55,5	57,4	57,4	57,1
Effect of pension reform	*1,4*	*1,7*	*2,3*	*3,1*	*3,7*

(*/: as compared to the new current-price GDP figures published on 29 September, the deficit for 2002 and 2003 becomes 0.1 percentage point lower, the debt ratio in 2002 0.5 percentage points, in 2003 0.7 percentage points, in 2004 0.2 percentage points lower.)

1.4 percentage point adjustment in 2006

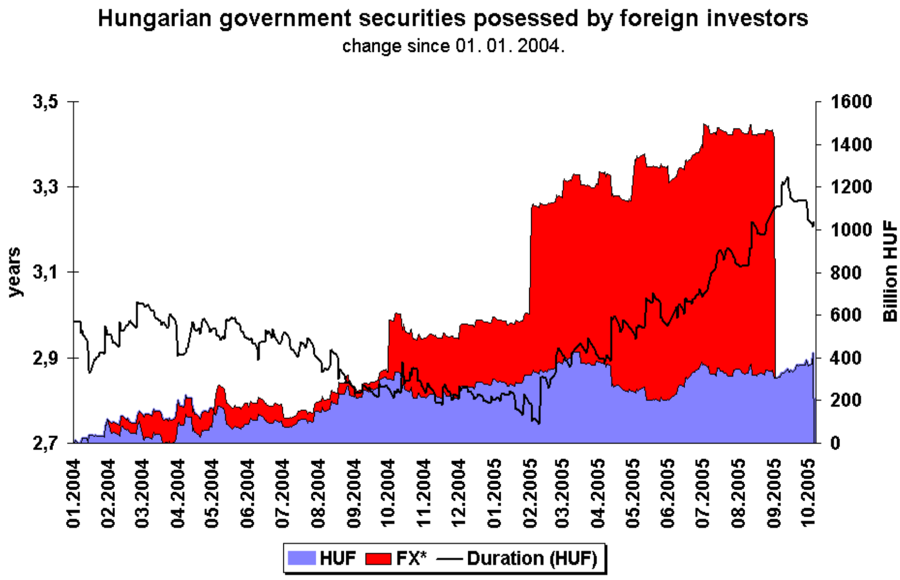
The submitted year 2006 budget sets the government deficit (including private pension funs) at 4.7% of GDP. The deficit will drop by twice the originally envisaged amount, at 1.4 percentage points of GDP, next year, but as a result of the higher starting level it is still higher than projected in the convergence programme.

Slowing debt growth in Q3

The debt of the central government increased to HUF 12,822.2 billion by end-September as indicated by preliminary figures. Of the HUF 1,229.9 billion increase since December 2004, HUF 814,1 billion resulted from the increase of foreign currency debt (foreign currency bond issuance of HUF 848.6 billion, net foreign currency borrowing of -90,8 billion, weakening of the Forint exchange rate HUF 56.4 billion), and the Forint debt increased by HUF 415.7 billion. Foreign fund raising was implemented this year mostly through bonds denominated in foreign currencies, and the share of non-residents within the Forint government security portfolio declined slightly. Most of the increase of the public debt was realised in the first half-year because of the uneven development of the budget deficit during the year.

Improving conditions until mid-September, meeting strategic objectives in financing

The conditions of financing continued to be favourable in the past quarter: no foreign currency denominated government bonds were issued, while on the Forint markets the T-bill auctions were generally met with keen interest and government bond auctions attracted average demand. Responding to the outstanding demand, the Government Debt Management Agency repeatedly increased the volume issued in case of both discount T-bills and government bonds, while the average yields at auctions declined until mid-September, but after that, mainly because of the Eurostat position relating to the year 2005 budget deficit and the uncertainties of the date of introduction of the euro, they started rising. In the course of financing, the Debt Management Agency focused on the objectives of the government debt management strategy, and it satisfied the requirements of the performance indicators through the government debt structure.



*Most recent data as of 31 August: 2005

The Forint government security holdings of non-residents have increased by some HUF 90 billion since the July Flash report, and the duration of the portfolio has moved slightly above the value at the beginning of the period.

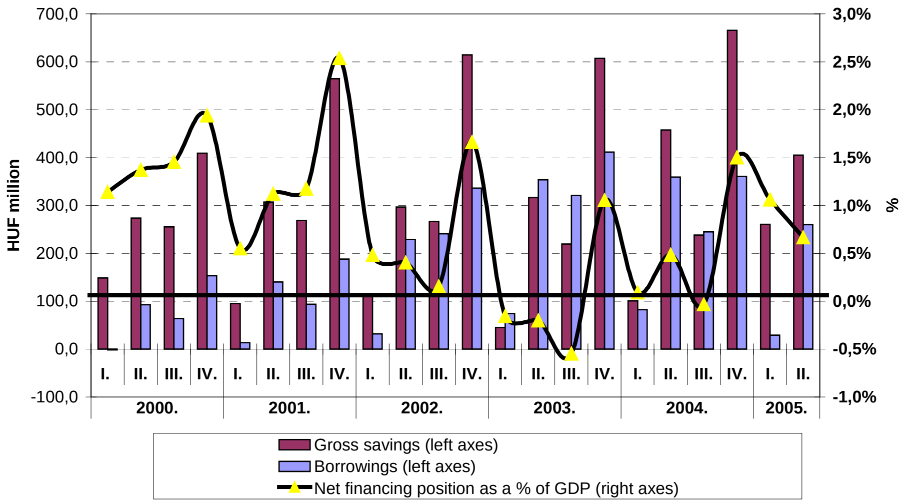
In aggregate, the central budget shows a surplus in Q4; therefore, in the remaining part of the year the public debt growth will come to a halt. Due to the uncertainty of the timing of certain cash flow items, however, the debt manager has devised different financing alternatives, with the EUR 0.5 billion foreign currency bond issuance proposed for October as one of its key elements.

4.3 Financial savings of households

The financing capacity of households improved in the first half-year

In the first half of this year, the net saving position of households improved by HUF 377 billion. Departing from the seasonal trends of past years, most of the increase arose in the first quarter.

Development of gross savings and borrowings of households and their net financing position as a % of GDP

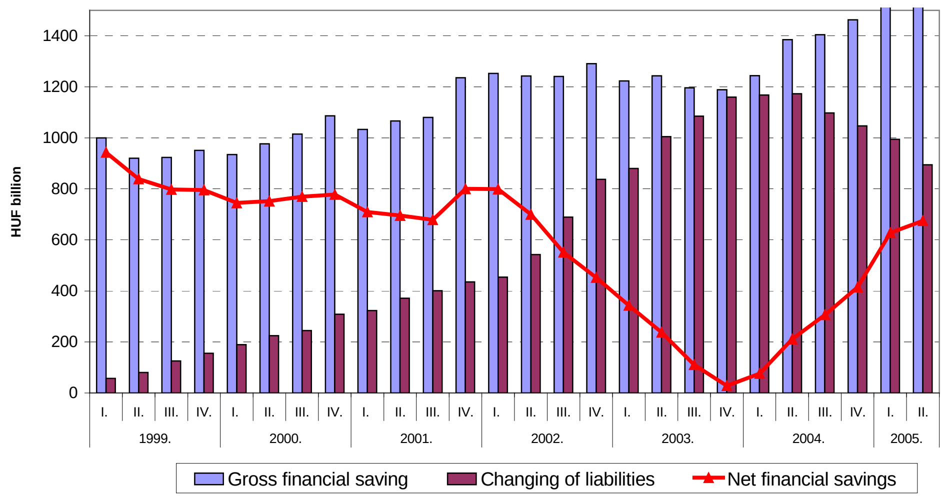


Foreign currency loans continue to dominate

Following the low values in Q1, the expansion of the credit stock of households resumed the approx. HUF 200-300 billion level seen in previous quarters. The most notable feature of the borrowing of households is the spread of foreign currency loans. In Q1, households borrowed 85% of their new loans in foreign currencies and in Q2 that figure rose to 89%, which - despite falling Forint interest rates - is explained by the significant currency-Forint interest rate differential, as well as the interests of the lending institutions. The foreign currency loans represented some 35% of the total loan stock in the middle of the year. During the first half-year, the foreign currency borrowing of households generated Forint demand of some EUR 1.4 billion, contributing to the maintenance the strong and stable Forint exchange rate.

Gross savings, similarly to the net figures, reached a relatively high level unusualy for the seasonal trends in Q1. The postponement of the 13th month salaries to January may have played a part in that. In Q1, the growth continued but at a rate below the corresponding period of the previous year. In the first half of 2005, the growth of investment units and pension and life insurance products predominated. The dynamic expansion of investment units is related to the declining deposit rates, while pension and life insurance products have been a steadily growing element within household savings due to the characteristics of the pension system. Within household savings, listed stocks continue to represent an extremely small proportion, at 1%.

Development of net financing position of households
(12 month accumulated values of transactions)



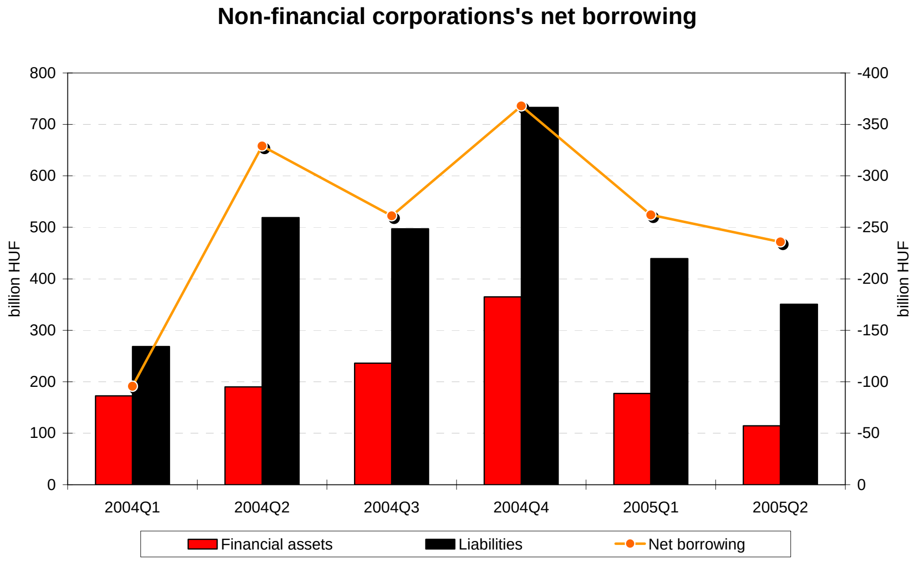
For the whole of 2005, the financing capacity of households may come close to 3% of GDP (approx. 1.5% after adjustment for pensions), which is almost one and a half times the previous year figure. As a typical development for this year, the Forint demand arising from the currency borrowing of households became a determining factor in the Forint market. The monthly growth rate of foreign currency borrowing is expected to be around EUR 300 million during the summer months as well, therefore the further increase of the ratio of the foreign currency debt stock is expected until the end of the year. Because of the VAT cut of next year, we reckon with declining credit demand below the usual levels and greater financial savings in the remaining part of the year. In terms of the structure of savings, the tends seen in the first half-year will continue in the second six months of 2005.

Growing savings reduce the external financing requirement

4.4 Corporate sector

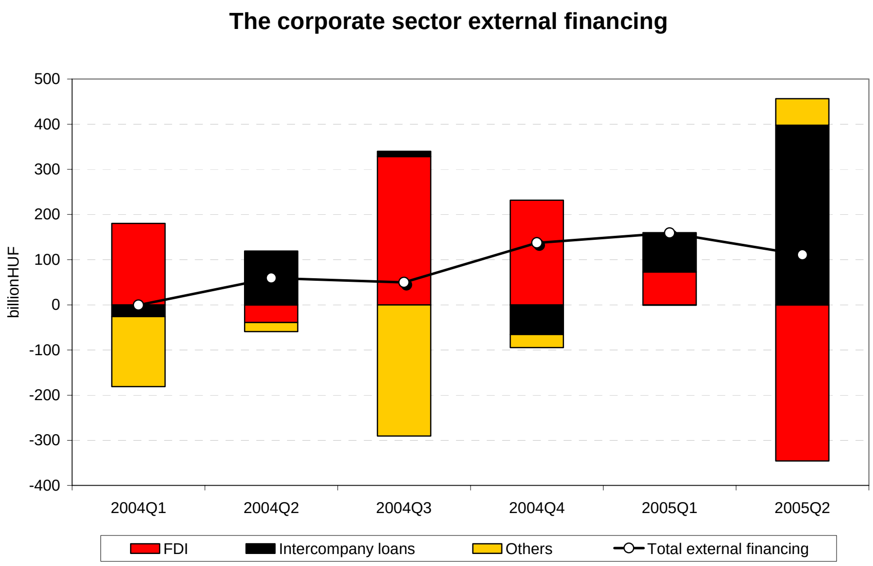
Following the steep rise of 2004, the growth rate of the financing requirement of the corporate sector (without credit institutions) declined slightly in the first two quarters of 2005. The financing requirement in the first half-year amounted to almost HUF 400 billion, satisfied mostly from foreign sources, domestic funding representing 15-20%.

Foreign funds dominate in financing



The structure of foreign financing underwent a significant change. Unlike in the previous period, non-residents, through equity capital trends, had a negative impact on the financing of the Hungarian economy. This manifested itself through the disinvestments of non-residents and also through the increased activities of Hungarian enterprises abroad. However, the decline of equity capital was offset and, indeed, significantly exceeded by the major expansion of the stock of intercompany loans, mostly due to the conversion of equity capital into debt. Other sources of funding also increased their share in Q2 as a result of the resumed growth of borrowing.

Equity capital replaced by intercompany loans in financing



Due to the uncertain global economic environment, only a slight upturn of the business cycle is to be expected for the remaining part of 2005, which foreshadows the continuation of the present demand and investment growth. Thus, if the favourable external financing conditions prevail, the financing requirement of enterprises will remain approximately at the present level.

4.5 External equilibrium[3]

The current account deficit and …

At the end of June 2005, the current account deficit was EUR 3,246 million, or 7.9 % of GDP. This represents and improvement of EUR 327 million, or 1.5 percentage points of GDP, over the EUR 3,573 million deficit at the end of the first half of the previous year. The improvement was the result of the substantial decrease of the trade deficit.

… the external financing need going down

Alongside the decreasing current account deficit, the capital account balance improved significantly: Hungary received additional funds of EUR 336 million through EU capital transfers. This further reduced the external financing need, bringing it down to 7.1% of GDP from last year's level of 9.6%.

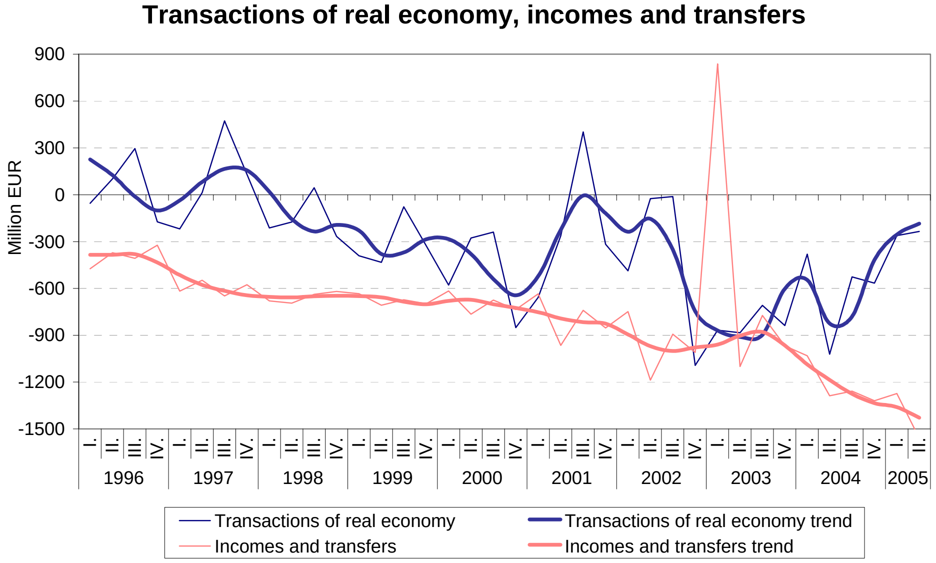
The deficit of the foreign trade balance was lower than last year…

The EUR 454 million deficit of the foreign trade balance was EUR 1.1 billion less than in the first half of the previous year, which corresponds to a change from 4% to 1.1% of GDP. However, for the assessment of the improvement, it must be noted that there is a significant basis effect on exports and imports alike, though in a different direction. Exports were low in the first four months, then they rocketed. Imports show an even greater difference. Due to the pre-purchases relating to our EU accession last year and the settlement of transitional items, the value of imports was unusually high. (For a detailed analysis, see page 9 of the Flash Report of 6 April 2005.) It was on the basis of that inflated import figure of last year that the significant import growth drop and equilibrium improvement occurred this year; the effects of this will gradually peter out in the second half-year. Thus a more moderate improvement of the foreign trade balance is expected for the whole of the year.

… but services did not improve the equilibrium

Services reduced the current account deficit by EUR 132 million last year, while this year they increased it by EUR 42 million.

[3] Based on the NBH data published on 30 September 2005 for the first half of 2005. Simultaneously, the NBH also revised the year 2003, 2004 and Q1 2005 figures.



The value of interest and dividend type income at EUR 2.8 billion was EUR 500 million up on the figure registered in the first half of 2004. Almost half of the increment resulted from the increase of incomes realised on the expanding foreign investments. The continuous expansion of the stock of foreign direct investments and the profitable operation of the capacities thus created is a positive development, and it necessarily goes hand in hand with the increase of dividend income in the balance of payments. In the continued favourable economic climate, owners are expected to re-invest a substantial part of the profit in Hungary thus expanding further their operations. The other half of the increment arose as a result of the greater debt stock and the continued high interest rates. As a consequence of the declining Forint yields, the interest expenditures paid to foreign investors will decline in the future, but the further decrease of the interest burden requires the slow-down or termination of the growth of indebtedness. Net income transfers became the predominant item in the current account deficit, reaching 6.9% of GDP as opposed to 6.1% last year.

The current transfers figure has been corrected retroactively for the year 2004, thus the incomes in this line increased to EUR 147 million in the base period. As compared to that, this year's inflow was EUR 82 million, less than last year, according to the figures in the first disclosure.

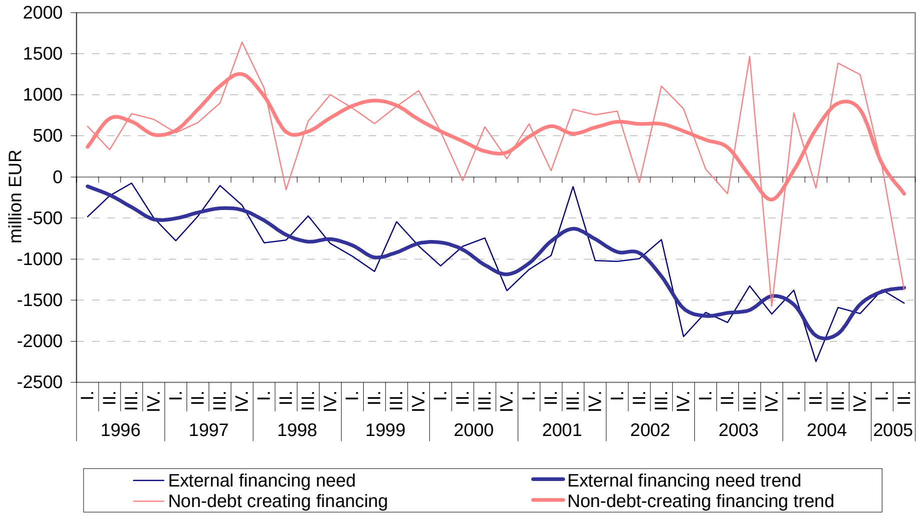
Based on the first half-year figures, the current account deficit for the entire year is likely to be in last year's range (EUR 7.1-7.3 billion), representing a declining percentage of GDP at 8-8.5 %. The external financing needs is expected to be lower given the improving capital account balance.

Foreign direct investment inflow continues to be dynamic

The inflow of foreign direct investments into the Hungarian economy continues to be favourable. Some EUR 2.4 billion FDI has been invested, over 1 billion EUR more than in the first half of last year. At the same time, the foreign investments of Hungarian residents also increased by approx. EUR 600 million, going above EUR 1.1 billion. As a combined result, the net direct investment inflows also increased by almost EUR 400 million, to EUR 1.3 billion.

Non debt creating financing produced a negative value of EUR 1.3 billion. This is partly because of the substantial increase in the capital investments of Hungarian residents abroad, in line with their regional expansion. On the other hand, non-residents made most of their direct investments in the form of intercompany loans in the first half of the year, which constituted debt creating items. At the same time, some EUR 500 million capital moved out through the portfolio channel in line with the international trends of the half-year. In contrast, there were some EUR 400 million of capital inflow in the first half of the previous year.

External financing need and non-debt creating financing



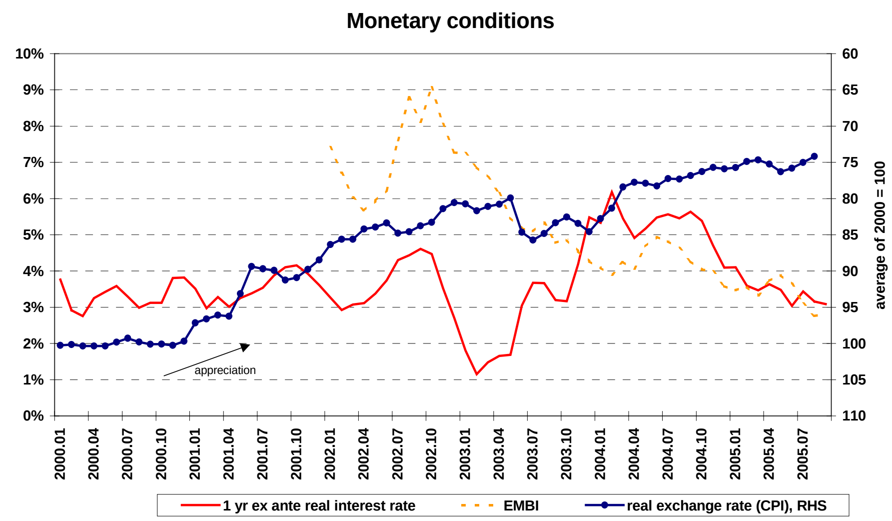
Net debt growth driven by the private sector

The gross debt (without intercompany loans and financial derivatives) increased by EUR 6.4 billion to EUR 51.8 billion in the first half of the year. Within that, the debt of the general government and the NBH increased by EUR 3.3 billion to EUR 26.7 billion, that of the private sector by EUR 3.1 billion to EUR 25.1 billion. The share of the private sector within gross debt has not changed (49%). At the end of June, the EUR 14.2 billion of international reserves exceeded the December 2004 level by 2.5 billion, which indicates that most of the borrowing of the general government occurred in foreign currencies, resulting in an increase in reserves. During the same period, the net debt (without other capital) increased from EUR 21.5 billion to EUR 24 billion; within that, the net debt of the general government and the NBH increased by EUR 290 million to EUR 12 billion, that of the privates sector by EUR 2.2 billion also to EUR 12 billion. Thus the share of the private sector within net debt increased from 46% at end-December to 50%.

5. Monetary developments

5.1 Monetary conditions

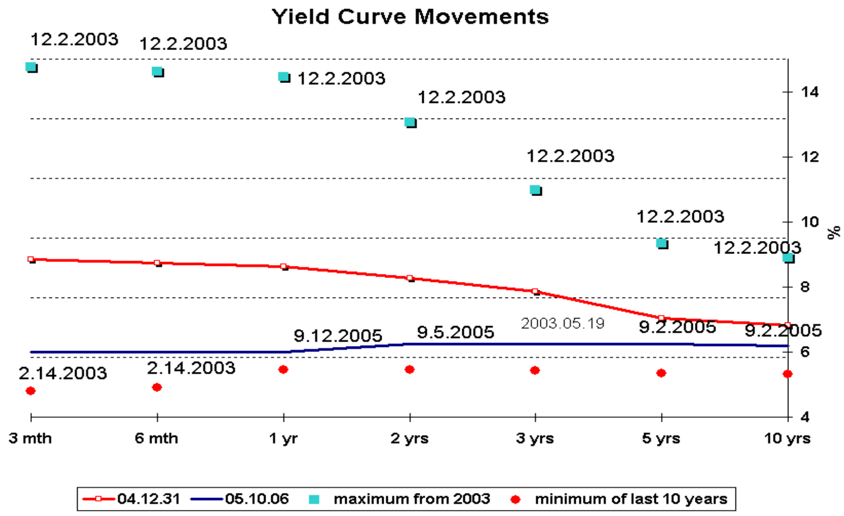
In Q3 of 2005, **monetary conditions** were relaxed on the whole. Real interest rates continued to decline, falling slightly below the long term average. All this happened while yields declined even more than inflationary expectations. The Forint was steadily strong, and the inflation differential to the euro area also narrowed substantially as compared to previous years, therefore the consumer price based real exchange rate was relatively stable, though rising slightly.



In the first nine months of 2005, the Monetary Council essentially followed market expectations. In each month, it reduced the base rate, essentially at the rate priced in the yield curve or indicated by surveys among analysts. This also contributed to the gradual downward shift of interest expectations: the base rate expected for the end of the year has fallen by 2.5 percentage points since the beginning of the year.

Monetary policy continues to be subject to conflicting factors: the international investment environment is favourable, inflation has stabilised around 3%, thus the economy achieved effective price stability, and inflationary expectations are also good – and not only because of the VAT rate cut for 2006. Nevertheless, the equilibrium position signals caution to interest rate policy.

On the other hand, the expediency of the excessive pessimism of the central bank seemed to have been contradicted by the significant downward shift in both the middle and long sides of the yield curve. The Hungarian yield curve reached the lowest level in the past decade in September, apart from the special circumstances in early 2003. The stability of the financial markets is shown by the fact that even the information published late September – early October (modification of budget deficit targets, uncertainty about the target date of euro introduction), which would normally have been decisive, failed to trigger drastic movements – even though long term yields and forward differentials, which indicate interest rate convergence, rose to the summer 2005 levels.

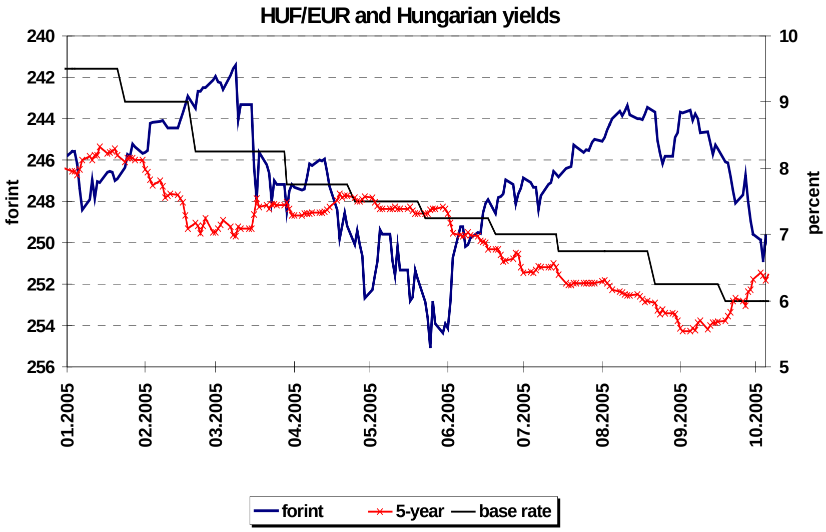


Hungarian real interest rates continue to be high by international standards, but their trend is declining.

5.2 Exchange rates

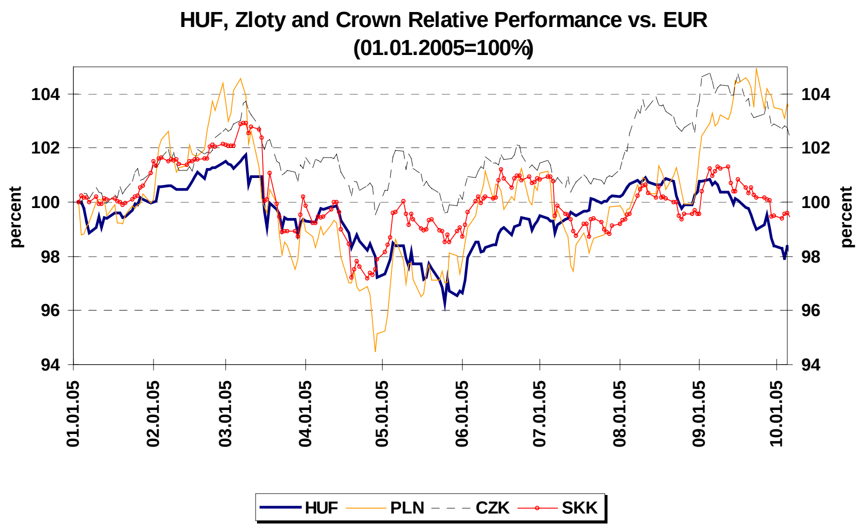
The exchange rate remains strong and stable

For considerably more than one year, since early July last year, the exchange rate has typically been stronger than the 250 HUF/EUR level, with the exception of May this year and the past few days, when it was slightly weaker. The favourable international and regional environment also contributed to the stability of the exchange rate. The strong and stable exchange rate continued to greatly facilitate the lasting deceleration of inflation and the attainment of the inflation targets of this year and next year. (With the joint decision of the Government and the NBH, the annual inflation targets have been replaced by a 3% medium-term inflation target as of 2007, which renders it likely that the 3%, meaning price stability in our circumstances, can be maintained in the long term as well.) According to the analysts' expectations, disclosed in the latest Reuters poll of 15 September, the exchange rate will continue to be strong around (250 HUF/EUR at end-2005, and 255 HUF/EUR at end-2006) across the entire time horizon (up to 2006), against the background of interest rates slightly lower than today.



Until early August, the movement of the Forint was not substantially different from the exchange rate trends of the Czech Crown, the Slovak Crown and the Zloty. The movement of these currencies was dominated by international events, the most important one being investors' expectations concerning dollar yields' developments. Recently the Czech Crown and the Zloty have performed significantly better than the Slovak Crown and the Forint. On the other hand, the fluctuations of the EUR/dollar rate were reflected in the dollar exchange rates of these currencies.

Recently the Czech Crown and the Zloty perform best among the currencies of the Visegrád countries



The previous Flash Reports placed emphasis on the real effective exchange rate indices when assessing competitiveness. However, conclusions drawn from the measurement of competitiveness with price and cost-based real effective exchange rate indices must be treated with caution. This is because of the structural and other characteristics of economies. In Hungary, there are a number of multinationals operating in leading exporting sectors, including manufacturing; these firms purchase the inputs for their production abroad and sell most of their

The competitiveness trends of the Hungarian economy are only partially reflected by the real effective exchange rate indices products abroad; manufacturing exports represent approx. 90% of our total exportation. Clearly, domestic price and cost trends have only minor importance for the competitiveness of these firms.

According to surveys of international institutes, our competitiveness position has improved

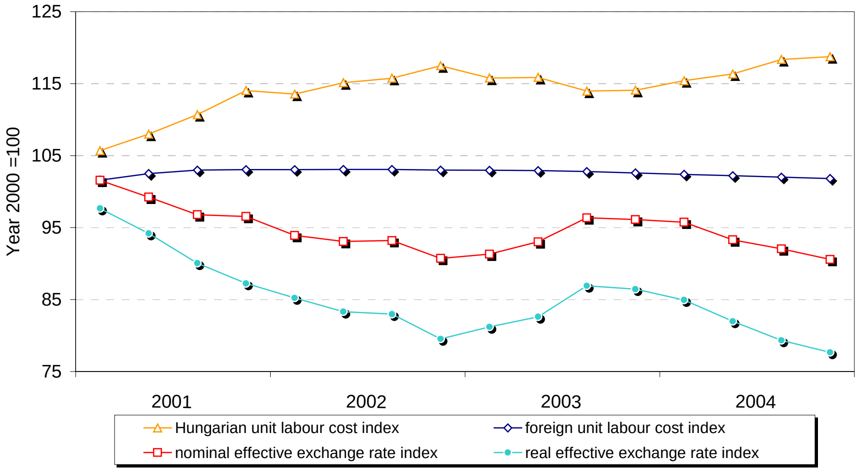
Competitiveness is universally governed by consistent economic polices assuring sustainable growth, the creation of an appropriate macro-economic, political, social and legal environment, the improvement of the micro-economic efficiency of the economy, the quality and extent of competition and the pro-entrepreneurial economic environment. On the whole, the surveys of various international institutes indicate that the competitiveness position of Hungary has improved over the past year, and returned to the level disclosed in the publications for the year 2002, which, taking into consideration the delayed availability of data as well, effectively means the recovery of our competitiveness position achieved in the years 2000-2001. (For more details, see the box).

Following a temporary improvement, our competitiveness measured with real effective exchange rate indices deteriorates again

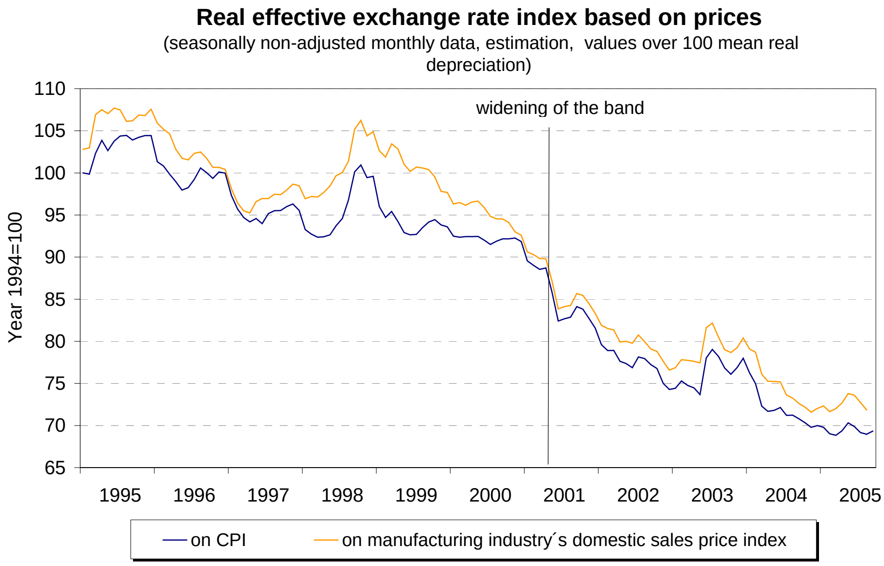
The competitiveness measured with the real effective exchange rate indices deteriorated significantly in recent years, the real exchange rate appreciating by approx. 22% on price basis and some 19% on unit labour cost basis between 2000 and 2004. Real appreciation was especially high in 2001-2002, followed by a gradual slow-down in the decline of competitiveness in 2003, while the deterioration re-emerged in 2004, to a large extent because of the strengthening exchange rate. In recent years real appreciation was driven, apart from nominal exchange rates, by the wage increases being substantially higher than the moderate productivity growth.

Real effective exchange rate index based on unit labour cost of manufacturing industry

(seasonally adjusted quarterly data, values over 100 mean depreciation)



Following the approx. 6% deterioration of price based competitiveness in 2004, significant real appreciation occurred on a year-on-year basis: 4.2% both on a CPI basis in the first nine months of 2005 and on a manufacturing PPI basis in the first eight months. Because of the strong exchange rate, despite the significant contraction of the inflation differential to our main trading partners, the CPI-based real appreciation will be higher in 2005 again that the 1-2%, which could be tolerated in the case of the fast-growing converging economies.



In the case of a small, open, fast-growing economy, the development of cost competitiveness plays a far more important role than price competitiveness. However, no year 2005 data about cost-based competitiveness are available yet.

Box
Competitiveness indicators

Competitiveness is a complex concept open for several interpretations. A number of indicators can be used for its analysis as well; even though their tendencies coincide, certain differences may occur due to the different calculation methodologies and approaches. The previous Flash Reports placed emphasis on **real effective exchange rate indices** when assessing competitiveness. Competitiveness is universally governed by consistent economic polices assuring sustainable growth, the creation of an appropriate macro-economic, political, social and legal environment, the improvement of the micro-economic efficiency of the economy, the quality and extent of competition and the pro-entrepreneurial economic environment.

A number of organisations approximate competitiveness trends by analysing **various composite indicators**. These include::

- **general indicators of the development of competitiveness** (IMD, World Economic Forum),
- **surveys indicating the general characteristics of the business environment,**
  - index of economic freedom (Heritage Foundation, Fraser Institute),
  - business friendly environment (World Bank), and
- surveys concerning the **convergence trends** (ICEG).

These indicators lend themselves to **conclusions concerning the past trend of competitiveness**, while, due to their nature, they give little guidance about the current status and expected development of competitiveness. The outcomes of the various surveys are also affected by changes in the countries surveyed and the indicators considered, which renders assessment more difficult. The different publication dates of the most recent papers of the various institutions also result in different pictures being painted about our competitiveness position among the countries. This year's publications show a more positive picture for Hungary that the ones published last year. This is in line with the fact that the most important economic policy achievement of 2004 was the resumption of the macro-economic path characterised by long term sustainable, sound growth. On the whole we can conclude that our competitiveness position improved over the past year and returned to the level disclosed in publications for the year 2002, which, taking into consideration the delayed availability of data as well, effectively means the recovery of our competitiveness positions achieved in 2000-2001. A more detailed description of the methodology of indicators is attached in the Annex.

Competitiveness indicators

Description	General competitiveness indicators									Index of economic freedom						Business friendly environ.	Convergence indicators		
	IMD			World Economic Forum						Heritage Foundation			Fraser Institute			World Bank	ICEG		
				GCI			BCI												
Country	2002	2004	2005	2002	2004	2005	2002	2004	2005	2002	2004	2005	2001	2002	2003	2005	2002	2004	2005
Cyprus	-	-	-	-	38	34	-	45	36	22	14	22	71	51	38	-	-	-	-
Czech Republic	32	43	36	36	40	38	34	35	27	28	32	33	40	41	44	41	3	2	2
Estonia	21	28	26	27	20	20	30	27	26	4	6	4	14	11	9	16	2	3	3
Poland	45	57	57	50	60	51	46	57	42	43	57	41	71	61	78	54	6-7	6-7	5
Latvia	-	-	-	43	44	44	45	49	48	37	30	28	42	36	44	26	5	8	8
Lithuania	-	-	-	39	36	43	40	36	41	31	23	23	61	44	44	15	4	5	7
Hungary	**30**	**42**	**37**	**29**	**39**	**39**	**28**	**42**	**34**	**25**	**42**	**35**	**30**	**22**	**20**	**52**	**6-7**	**6-7**	**6**
Malta	-	-	-	-	32	35	-	50	46	52	37	29	53	44	50	-	-	-	-
Slovenia	35	45	52	26	33	32	27	31	32	86	52	46	77	74	70	63	1	1	1
Slovakia	38	40	40	46	43	41	42	39	39	49	35	36	67	51	54	37	8	4	4
Greece	36	44	50	31	37	46	43	41	40	56	54	59	42	41	38	80			
Italy	34	51	53	33	47	47	24	34	38	26	26	26	35	36	54	70			
Portugal	33	39	45	19	24	22	36	33	30	29	31	38	24	27	34	42			
Spain	23	31	38	20	23	29	25	26	25	34	27	31	35	31	30	30			

Notes to the table:

International Institute for Management Development (IMD) World Competitiveness Yearbook, May 2005. Since 2003, IMD has added 8 developed regions to the competitiveness ranking, 5 of which (Bavaria, Zhejiang in China, Catalonia, Ile-de-France, Rhone-Alps) came before us, together with Scotland, which was added in 2004. Thus the improvement of our competitiveness by 5 positions, ranking us 37th, means that our position has not effectively changed since 2002.

World Economic Forum Global Competitiveness Report, September 2005. The comparison of our positions in 2002 and 2005 is again adversely affected by the fact that, in terms of the GCI index, 2 countries that had not been included in the year 2002 survey attained ranks before us in 2003 (Luxembourg, Malta), 3 in 2004 (Bahrain, Cyprus, United Arab Emirates) and 2 in 2005 (Qatar, Kuwait); in terms of the BCI index, one such country came before us in 2004 (United Arab Emirates).

Based on the year 2005 Index of Economic Freedom published early in 2005 by the Heritage Foundation and the Wall Street Journal.
Based on the Economic Freedom of the World Index published by the Fraser Institute in September 2005; according to the published index, several countries may have the same ranking.
Doing Business in 2006, a joint publication the World Bank and the International Finance Corporation, September 2005.
ICEG European Centre and Világgazdaság: Convergence index of new Member States, May 2005.

Annex

General competitiveness indicators

The best known of these is the World Competitiveness Index, the competitiveness indicator of the **International Institute for Management Development (IMD)**, which is published annually in the World Competitiveness Yearbook. For the preparation of the ranking, the IMD focuses on four key areas: economic performance, efficiency of the government and business sectors, infrastructure. The yearbook published this May used 314 indicators for the calculations. The index thus derived combines quantitative and qualitative considerations, combining approx. 128 statistical indicators and 113 criteria derived from a questionnaire survey of business executives. (Another 73 indicators are used by IMD as background information, and they are not considered for the computation of the aggregate competitiveness index.) The IMD ranking covers 60 countries and developed regions.

Another, though slightly less frequently quoted, general indicators of competitiveness is disclosed in the annual publication 'Global Competitiveness Report' of the **World Economic Forum** (WEF). This September, having applied a number of indicators and interviewed some 11000 business executives around the world, the WEF published two main indices of competitiveness: one is the GCI (Growth Competitiveness Index) signalling growth potentials sustainable in the medium and long term, the other one is the BCI (Business Competitiveness Index) showing business competitiveness. The GCI summarises the indicators of three areas: quality of the macroeconomic environment, state of public institutions and the level of technological readiness; for this, they use statistical data and survey information. (In next year's publication, GCI will be replaced by the Global Competitiveness Index, an improvement on the former, as the focal point; this was calculated in 2005 as well, but this year's publication does not disclose the complete ranking of countries. The new index encompasses nine areas, namely: institutions, infrastructure, macroeconomy, health and primary education, higher education and training, market efficiency, technological readiness, business sophistication, innovation). The BCI is a supplement to the medium-term, macroeconomic GCI, reflecting fundamental micro-economic factors that determine the present sustainable level of productivity and thus the development of per capita GDP in the various countries. The index synthesises the operation and strategies of companies and the development of the business environment. The micro-economic index relies on data from interviews with business leaders and government officials. In 2005, the GCI was calculated for 117 countries, the BCI for 116 countries. (The number of countries increased substantially in 2003, from 80 to 102, while no substantive change happened in 2004.)

Surveys of the general characteristics of the business environment

As its name shows, the **Index of Economic Freedom** focuses on one important factor of the competitiveness of countries, but it is defined for many countries using a number of indicators, therefore it allows for conclusions concerning the general competitiveness of the economy as countries with greater economic freedom achieve higher long-term growth rates and have greater prosperity than economically less free counties. The year 2005 Index of Economic Freedom, published by the **Heritage Foundation and the Wall Street Journal** early in 2005, measures economic freedom based on 50 indicators representing the 10 most important factors of the economic freedom (trade policy, fiscal burden of government, government intervention in the economy, monetary policy, capital flows and foreign investment, banking and finance, wages and prices, property rights, regulation, informal market activity including corruption) in respect of 161 countries. The Economic Freedom of the World Index (EFW) published by the **Fraser Institute** in September 2005 summarises, in respect of 127 countries, the data that were available, mostly relating to the year 2003. The index contains 38 variables, 18 of which is survey-based. The index measures the degree of freedom of the economy in 5 areas: size of government (expenditures, taxes, enterprises), legal structure and security of property rights, access to sound money, freedom to trade internationally, and the regulation of credit, labour and business.

„Doing Business in 2006”, published by the World Bank this September, concentrates on the **business-friendly environment**, reviewing ten topics based on the information available in January 2005 in respect of 155 countries: starting a business, dealing with licenses, hiring and firing, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, closing a business. (In the similar World Bank publications of 2004 and 2005 fewer countries and, more importantly, fewer topics were covered, and the complete ranking of countries was not published). ‘Doing Business in 2006’ publishes the complete ranking of countries, the competitiveness ranking is determined by the average of the ranks awarded in each of the ten topics, derived by calculating the average of the rankings based on the component indicators of the topic.

Convergence indicators

Convergence indicators also show competitiveness trends. Indicators of that kind were regularly published, before enlargement, by Deutsche Bank and Dekabank. **ICEG European Centre and Világgazdaság** prepared the convergence index of new Member States again in May 2005. The first such index was published in December 2002, with semi-annual updates. The index uses ten macroeconomic indicators showing the nominal, structural and real convergence of eight new Member States (without Malta and Cyprus) to present where these countries are in the convergence process compared with each other and with the EU averages. Most of the indicators relate to the nominal, and some to the real convergence of the new Member States, and two indicators give information about structural convergence. The indicators used for the calculation of the index: inflation, budget deficit, government debt, current account deficit (nominal convergence), growth rate of the economy, wage and price levels, as well as per capita GDP (real convergence), the ratio of agricultural workers to total employees and the legal environment of business based on a complex indicator borrowed from the EBRD (structural convergence). More weight is accorded to the stock variables (price and wage level, per capita GDP), while the more hectically fluctuating, so-called flow indicators (inflation, budget balance etc.) have relatively less importance. Thus the index contains both indicators that show whether the country complies with nominal convergence criteria and those that show where the economy stands in real development and to what extent important structural indicators depart from the EU average. It should be noted about the index that this is a complex indicator measuring nominal, real and structural convergence, therefore the increase of its value does not necessarily entail a change of all components to the same extent and in the same direction. The increase of the value of the indices is attributable primarily to the achievements in nominal and structural convergence, while progress in terms of real convergence was more modest and more scattered. Therefore progress should not be interpreted as a change in the level of development or in income levels. On a scale of 0 to 10, 10 would be awarded to an economy that meets the criteria of nominal convergence and has structural indicators at the EU average, and its growth rate is at least twice the EU average.

TABLES

Table 1.

Economic indicator (cumulative data, from the beginning of the year)

1. Real sector, Prices, Competitiveness

change from the same period of previous year

	2000	2001	2002	2003	2004				2005								
					I quarter	I. half of year	I-III. quarter	I-IV. quarter	1. month	1-2. month	I. quarter	1-4. month	1-5. month	I. half of year	1-7. month	1-8. month	I-III. quarter
GDP volume	5,2	3,8	3,5	3,4	4,5	4,5	4,3	4,2	-	-	2,9	-	-	3,5	-	-	-
Household consumption	4,9	6,0	9,4	7,8	1,9	2,8	3,0	2,5	-	-	2,1	-	-	2,7	-	-	-
Government consumption	1,2	5,3	5,7	6,5	-2,1	-2,5	-2,7	-3,9	-	-	0,4	-	-	0,4	-	-	-
Gross fixed capital formation	7,7	5,9	9,3	2,5	18,4	13,1	12,7	7,9	-	-	6,8	-	-	8,3	-	-	-
Domestic use	4,8	2,0	5,5	6,2	0,8	2,7	2,8	2,2	-	-	0,7	-	-	-0,8	-	-	-
Export of goods and services	22,0	8,0	3,9	7,8	19,3	19,3	16,4	14,9	-	-	7,0	-	-	9,1	-	-	-
Imports of goods and services	20,3	5,3	6,5	11,1	13,5	15,8	13,6	11,6	-	-	4,5	-	-	4,0	-	-	-
Volume of investment	7,4	3,5	7,8	2,2	18,9	13,5	13,2	7,8	-	-	6,8	-	-	8,3	-	-	-
Volume of industrial production	18,1	3,6	2,8	6,4	9,9	9,8	8,2	7,4	3,6	2,2	2,0	3,9	5,8	5,9	5,9	6,7	-
Volume of construction	7,5	8,3	17,8	2,0	15,4	7,2	5,9	5,8	9,5	15,4	9,8	11,3	10,5	13,8	14,6	-	-
Foreign trade turnover: export volume	21,7	7,8	6,8	9,1	20,1	21,3	19,7	18,4	8,1	7,1	6,6	9,0	9,3	8,9	8,2	9,2	-
import volume	20,8	4,0	6,1	10,1	16,1	19,2	17,1	15,2	8,4	6,1	3,7	2,1	2,0	1,8	1,9	3,4	-
Volume of retail trade turnover	2,0	5,4	10,7	8,4	5,2	7,4	6,4	5,6	1,8	1,5	2,9	2,3	2,8	3,1	3,2	-	-
Number of employees (in thousands) 2/ -household survey	3 829,1	3868,3*	3 870,6	3 921,9	3 891,5	3 892,8	3 897,4	3 900,4	3 864,3	3 864,3	3 870,6	3 872,3	3 877,3	3881,1	3888,1	3892,2	-
-labour statistics	2 698,4	2 722,0	2 726,3	2 753,0	2 768,9	2 784,8	2 791,5	2 789,6	2 774,8	2 773,8	2 773,4	2 776,5	2 780,4	2783,8	2786,0	-	-
Vacancies (in thousands) 3/	39,2	37,3	34,0	44,0	48,6	53,0	51,8	48,2	34,1	35,7	35,9	38,3	39,9	40,8	41,3	41,5	-
Number of unemployed (in thousands) 3/	372,0	342,8	344,9	359,9	395,5	379,5	373,8	376,0	430,3	434,8	435,3	431,3	424,9	418,8	415,9	413,9	-
Rate of unemployment (household survey, %)	6,4	5,7	5,8	5,9	6,1	6,0	6,0	6,1	7,2	7,1	7,1	7,2	7,2	7,1	7,1	7,2	-
Consumer price index	- 9,8	9,2	5,3	4,7	6,8	7,1	7,0	6,8	4,1	3,6	3,6	3,7	3,6	3,7	3,7	3,7	3,7
Index of industrial domestic sale prices	14,5	9,4	1,6	5,0	7,2	8,2	8,5	8,4	10,6	10,3	10,2	10,2	9,9	9,7	9,5	9,2	-
Index of industrial export sale prices	8,6	1,5	-4,5	0,3	2,1	1,3	0,2	-0,4	-1,3	-1,6	-0,7	-0,1	0,5	0,7	0,8	0,8	-
Agricultural production prices	22,5	4,9	-1,1	5,3	14,5	14,7	3,4	-5,4	-13,3	-13,8	-12,9	-11,9	-11,5	-10,5	-6,2	-	-
Competitiveness 10/:																	
based on CPI	-5,4	-7,7	-9,1	-1,4	-0,4	-2,6	-4,7	-5,8	-8,5	-8,2	-7,1	-6,1	-5,3	-5,0	-4,7	-4,5	-4,2
based on manufacturing prices	-1,8	-9,0	-7,8	-0,9	0,6	-2,0	-4,5	-5,7	-8,6	-8,8	-7,6	-6,6	-5,7	-5,1	-4,5	-4,2	-
based on ULC (value added)	-2,8	-7,8	-10,3	1,8	4,6	1,9	-1,8	-3,9	-	-	-	-	-	-	-	-	-

Table 2.

Economic indicator (cumulative data, from the beginning of the year)
2. Income and Monetary Aggregates

change from the same period of previous year

	2000	2001	2002	2003	2004				2005								
					I quarter	I. half of year	I-III. quarter	I-IV. quarter	1. month	1-2. month	I quarter	1-4. month	1-5. month	I. half of year	1-7. month	1-8. month	I-III. quarter
Average earnings : gross 1/	13,5	18,0	18,3	12,0	9,2	8,5	7,9	6,1	26,2	17,5	13,8	12,1	11,7	10,9	10,4	-	-
net 1/	11,4	16,2	19,6	14,3	8,0	7,5	7,0	5,7	23,2	16,5	13,7	12,4	12,2	11,6	11,2	-	-
Household: savings (HUF billion)	1 032,3	1 146,9	1 220,1	1 184,3	229,2	590,0	845,0	1 401,5	-	-	525,1	-	-	974,5	-	-	-
credits (HUF billion)	240,6	379,3	778,2	1 163,3	201,5	467,6	719,3	1 041,3	-	-	126,4	-	-	389,4	-	-	-
General government GFS balance (HUF billion) 4/	-480,2	-444,0	-1 685,6	-1 103,5	-434,7	-1 040,2	-1 284,1	-1 327,9	-198,4	-393,9	-484,9	-710,0	-837,7	-988,1	-936,4	-996,4	-1 059,5
Central budget GFS balance (HUF billion)	-368,7	-402,9	-1 469,6	-732,4	-364,9	-855,8	-1 035,8	-904,5	-199,1	-379,0	-373,1	-589,0	-680,5	-798,6	-741,3	-769,0	-780,9
primary balance (HUF billion)	329,7	212,9	-832,0	-4,1	-186,3	-398,0	-412,8	-103,0	-167,7	-217,4	-189,9	-288,5	-338,4	-341,5	-267,4	-224,4	-
revenue change 4/	14,2	10,5	7,1	13,3	8,1	5,6	4,9	8,0	26,7	19,6	22,3	10,6	11,1	15,6	16,5	18,3	16,9
expenditure change 4/	13,7	10,4	30,3	-2,7	17,3	19,4	15,4	10,0	23,2	27,6	17,6	16,2	15,7	9,6	9,3	10,4	7,6
Social Security Funds 5/: balance	-81,4	-28,8	-100,9	-349,0	-91,3	-208,2	-284,5	-423,9	-9,8	-38,4	-136,9	-153,9	-186,0	-220,6	-240,3	-271,9	-320,7
revenue change	10,7	18,6	17,2	4,6	8,5	9,5	10,1	7,9	24,1	26,8	11,1	15,9	17,7	11,8	13,4	14,6	10,6
expenditure change	12,5	14,9	20,4	14,2	9,2	11,1	10,2	9,6	2,1	6,6	15,7	14,4	10,7	11,1	11,2	11,1	10,9
Government paper benchmark yields (average annual) 6/																	
3 month	11,8	9,8	8,2	12,0	12,1	11,5	11,0	9,1	8,8	8,2	7,3	7,4	7,3	6,9	6,5	6,1	5,7
12 month	11,6	9,2	8,0	11,7	11,2	11,1	10,8	8,7	8,5	7,5	7,2	7,4	7,4	6,9	6,4	5,9	5,6
3 year-bonds	10,7	8,2	7,4	10,2	10,4	10,6	10,4	8,5	8,1	7,9	7,2	7,5	7,4	6,6	6,2	5,9	5,6
5 year-bonds	9,1	7,7	7,0	9,3	9,3	9,4	9,5	7,9	8,2	7,2	7,4	7,2	7,2	6,9	6,4	6,1	5,8
10 year-bonds	9,0	7,1	6,5	8,0	8,2	8,5	8,6	7,1	7,4	6,6	7,1	6,8	7,0	6,7	6,3	6,0	5,8
15 year-bonds		6,7	-	-	-	-	8,3	-	6,8	-	6,7	6,9	-	6,4	-	5,8	-
Interest rates 6, 7/:			-	-													
with maturity less than a year: credit	12,8	11,2	9,7	13,4	13,5	13,3	12,9	11,0	10,4	9,9	9,3	9,0	8,6	8,5	8,3	8,5	
deposit	9,5	8,4	7,4	11,0	11,2	10,6	10,3	9,1	8,6	8,0	7,4	7,0	6,5	6,3	6,2	5,8	
with maturity more than a year: credit	13,4	11,2	9,7	13,0	13,5	12,2	12,9	11,2	10,5	11,0	10,4	10,3	10,7	9,6	10,8	9,6	
deposit	9,4	7,7	8,0	10,8	8,0	10,7	10,0	8,3	7,5	7,0	5,2	6,7	5,2	6,1	6,0	5,0	
Balance of current account (EUR million)	-4 352	-3 577	-4 929	-6 382	-1 324	-3 573	-5 339	-7 136	-	-	-1 545	-	-	-3 246	-	-	-
External financing need (EUR million)	-4 053	-3 219	-4 727	-6 414	-1 378	-3 625	-5 214	-6 876	-	-	-1 374	-	-	-2 910	-	-	-
Non debt creating financing (EUR million)	1 340	2 303	2 670	-11	780	645	2 032	3 278	-	-	123	-	-	-1 251	-	-	-
Foriegn direct investment inflows (millió EUR)	2 998	4 391	3 185	1 887	764	742	2 089	3 236	-	-	1 074	-	-	2 418	-	-	-
Net foreign debt (EUR million) 9/	9,7	8,4	11,5	16,6	17,3	19,2	20,3	21,5	-	-	22,0	-	-	24	-	-	-
BUX index 3/	7 865	7 122	7 739	9 627	10 992	11 537	12 647	14 743	15 553	18 383	17 108	16 378	16 908	18 741	20 723		

METHODOLOGICAL REMARKS

for Table 1 and 2

Signs: * Preliminary data; **.** : data is not available yet; **-** : no data for the period

1/ In public sector the data for december of 2004 and for the year 2005 are corrected with the regulation-change of the additional one month salary, MoF estimate;

2/ Data for firms with more than 5 employees and for budgetary institutions total.

3/ End of period data.

4/ Excluding privatization receipts and contributions paid into the compulsory funded pension funds. At the general government the interim data do not include the local governments.

5/ Total revenues and expenditures of the Pension Fund and Health Fund are not consolidated with the non-self-provided services.

6/ The yield or interest in the last month of the period.

7/ At deposits with maturity longer than a month but not longer than a year.

8/ M3 does not include deposits with an agreed maturity over 2 years and debt securities with over 2 years' agreed maturity issued by motetary financial institutions. However, it includes holdings by residents other than monetary financial institutions of MNB bonds with up to 2 years' agreed maturity plus holdings by residents other than monetary financial institutions of investment units issued by money market funds.

9/ Excluding intercompany loans

10/ Price based indicators seasonally non-adjusted, unit labour cost based indicators seasonally adjusted

11/ Including sales of motor vehicles and antomative fuel